Notre Dame Law Review

Volume 53 | Issue 3 Article 3

2-1-1978

Student Comments

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STUDENT COMMENTS

I. Constitutional Law

CIVIL RIGHTS—PROCEDURAL DUE PROCESS FOR STUDENTS—COMPENSATORY DAMAGES ARE RECOVERABLE FOR A DENIAL OF PROCEDURAL DUE PROCESS EVEN THOUGH NO INDIVIDUALIZED INJURY IS SHOWN.

*Piphus v. Carey**

I. Introduction

In 1973 the Supreme Court held that public school students who have been denied their right to an evidentiary hearing when faced with the possibility of suspension from school have a cause of action.[1] In *Piphus v. Carey,* the United States Court of Appeals for the Seventh Circuit addressed yet another aspect of this expanding area of the law. In *Piphus,* the court considered the question of whether a student who has been denied this hearing may recover compensatory damages for the violation of procedural due process without showing any "individualized injury."[2]

Two public school students, Silas Brisco and Jarius Piphus, brought separate actions following their suspensions from school. On September 11, 1973, Silas Brisco was suspended from the Clara Barton Elementary School in Chicago, Illinois. School officials had decided that male students would be prohibited from wearing earrings because it was believed that they were a sign of gang membership.[3] Brisco's suspension resulted from his refusal to remove an earring when requested to do so by the school principal.[4] Brisco claimed that wearing the earring was a symbol of black pride and was not meant to denote gang membership. A 20-day suspension was imposed[5] upon Brisco despite the fact that there had been no determination by an independent fact-finder as to the significance of wearing the earring.[6]

Jarius Piphus received a 20-day suspension from the Chicago Vocational High School. A school official had seen Piphus and another student passing around an irregularly shaped cigarette, and had smelled what he believed to be marijuana. No marijuana was found, however, and Piphus denied the charge. There was no hearing conducted on that or any other factual issue. Instead, the officials followed the "usual procedure" of imposing a 20-day suspension for the violation of the rule prohibiting the smoking of marijuana.[7]

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* 545 F.2d 30 (7th Cir. 1976), *cert. granted,* 430 U.S. 964 (1977).

1 Goss v. Lopez, 419 U.S. 565 (1975).

2 545 F.2d 30, 31 (7th Cir. 1976).

3 Push v. Carey, Nos. 73C2522 and 74C303 consolidated (N.D. Ill. 1975).

4 *Id.*

5 Brisco's suspension actually lasted 17 days as he was voluntarily readmitted to school while a motion for a preliminary injunction was pending.

6 Push v. Carey. Note the potential first amendment issue involved here. If school officials could not "reasonably . . . forecast substantial disruption of or material interference with school activities" by Brisco's wearing the earring, such would be an unconstitutional denial of his right to freedom of expression. Tinker v. Des Moines Independent Community School District, 393 U.S. 503, 514 (1969).

7 Push v. Carey. *See* note 3 *supra.*

Brisco and Piphus instituted civil rights actions in the United States District Court for the Northern District of Illinois. Their claims were brought under 42 U.S.C. § 1983, which provides relief against individuals who, "under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory . . . ," have deprived "any citizen of the United States or any other person within the jurisdiction thereof . . . of any rights, privileges, or immunities secured by the Constitution and laws . . ." of the United States.[8] It was alleged that the defendant members and agents of the Board of Education of the City of Chicago had denied them procedural due process by suspending them from school without the requisite evidentiary hearing.

In finding that Brisco and Piphus were not afforded their constitutionally required evidentiary hearings,[9] the district court relied upon the recent Supreme Court case of *Goss v. Lopez*.[10] In *Goss* the Supreme Court held that a public school student was entitled to at least an informal evidentiary hearing where the student was faced with a sanction of suspension.[11] The right to a hearing was not to be absolute. Students who posed an immediate threat of disrupting the school could be suspended immediately. In such cases, however, an evidentiary hearing was to be provided as soon as practicable.[12] The Court also suggested in dicta that a more formal evidentiary hearing should be required for suspensions of over 10 days.[13]

In the cases of both Brisco and Piphus no evidentiary hearings were provided. Thus, the district court held that the school officials had denied the students the hearing to which they were entitled. This constituted a denial of procedural due process as guaranteed by the fourteenth amendment.

The district court relied upon the Supreme Court's decision in *Wood v. Strickland*[14] in determining whether the defendants could be held liable for damages. In *Wood,* the Supreme Court asserted that school officials have a qualified immunity under § 1983. Specifically, the Court held that damages could not be awarded if a school official had acted in good faith.[15] The Court made clear, however, that "good faith" immunity is not available to a school official if: 1) he knew or reasonably should have known that the action taken would be violative of the student's constitutional rights;[16] or 2) the action was taken with the malicious intention of depriving the student of his constitutional rights or causing other injury to the student.[17]

Applying the *Wood* criteria to the instant case, the district court found that the defense of good faith immunity was not available to the school officials because the defendants should have known that the students were entitled to some

8 42 U.S.C. § 1983.
9 Push v. Carey. *See* note 3 *supra.*
10 419 U.S. 565 (1975).
11 *Id.*
12 419 U.S. at 582.
13 419 U.S. at 584.
14 420 U.S. 308 (1975). The Court also discussed the policy reasons for this grant of limited immunity. To hold otherwise would constitute a form of "intimidation" upon the decision-making process in the schools. 420 U.S. at 319.
15 *Id.*
16 As a school official, one is held to a standard which presumes knowledge of the basic unquestioned constitutional rights of students. 420 U.S. at 322.
17 420 U.S. at 322.

sort of hearing.[18] Therefore, damages could be awarded under the *Wood v. Strickland* standard. However, compensatory damages were denied because of the plaintiffs' failure to quantify their damages.[19] The plaintiffs sought appellate review of this holding by the district court.

On appeal, the Seventh Circuit considered the question of whether Silas Brisco and Jarius Piphus were entitled to recover compensatory damages for deprivation of procedural due process without proving any individualized injury. It was therefore necessary for the court to determine whether injury was inherent within the denial of due process. The district court had not seen such inherent injury: it required the plaintiffs to show individualized injury in order to recover compensatory damages.

II. The Seventh Circuit—Damage Inherent in Procedural Due Process

In *Piphus v. Carey* the Seventh Circuit held that compensatory damages are recoverable for a violation of the constitutional right to procedural due process regardless of whether individualized injury is shown.[20] Concluding that injury "was inherent in the nature of the wrong," the court analogized the instant case to those cases in which recovery was allowed "for the deprivation of voting rights and other constitutional rights."[21] The only specific authority offered in support of this holding was the previous Seventh Circuit case of *Hostrop v. Board of Junior College District No. 515*.[22]

In *Hostrop* the plaintiff was summarily dismissed by the defendant college board from his position as president of the college. Hostrop thereafter brought suit in federal court, alleging that he had not been afforded his right to procedural due process. The court allowed plaintiff to recover, holding that:

> Plaintiff is entitled to damages for that constitutional violation. Although, the amount of damages for such an injury cannot be determined by reference to an objective standard, recovery of non-punitive damages for the deprivation of intangible rights for which no pecuniary loss can be shown is not without precedent. Courts have traditionally assessed such damages for tortious injury.[23]

The Seventh Circuit, in both *Hostrop* and *Piphus,* found injury inherent

18 Push v. Carey. Although the Supreme Court had not yet decided the *Goss* case, the district court concluded that the law in the Seventh Circuit as expressed in Linwood v. Board of Education of the City of Peoria, 463 F.2d 763 (7th Cir.), *cert. denied,* 409 U.S. 1027 (1972), was clear enough to hold the defendants to have known the constitutional rights of the students under those circumstances. This finding was not challenged by the defendants on appeal.

19 *Id.* The district court dismissed the complaint without awarding any relief although it acknowledged in the course of its memorandum opinion that declaratory relief would be appropriate.

20 545 F.2d at 32.

21 545 F.2d at 31.

22 523 F.2d 569 (7th Cir. 1975), *cert. denied,* 425 U.S. 963 (1976). Judge Tone wrote the opinions in both *Piphus* and *Hostrop*. In *Hostrop* the principle at issue was buried in an opinion concerned with several issues. The brief *Piphus* opinion highlights the Court's treatment of the damages question.

23 *Id.* at 579. The court in *Hostrop* was correct when it pointed out that non-punitive recovery has been allowed for the deprivation of civil rights, but the court did not discuss the cases that have held to the contrary.

within a denial of procedural due process.[24] In reaching that conclusion, the court analogized to compensatory awards in the voting rights context. This analogy was made, however, without examining the nature of the respective rights. Such an examination would have revealed that a voting rights violation is distinguishable from a procedural due process violation. In the final analysis, the two constitutional rights are particularly distinguishable when the focus is upon the nature of the compensable injury.

III. Damages in the Voting Rights Context
The Supreme Court

The availability of compensatory damages for constitutional violations is an unsettled question. The Supreme Court has addressed the issue only in the very narrow context of voting rights. Several of the circuits have dealt with the question of whether compensatory damages are recoverable for the technical violation of constitutional rights. The circuits have, however, established varying and often contradictory standards. This confusion results from the courts' failure to examine the constitutional right involved and the nature of the injury caused by the violation of that right.

In *Nixon v. Herndon*[25] the Supreme Court reviewed the dismissal of a complaint brought by a black citizen who had been denied the right to vote in a primary election. A Texas statute prohibited blacks from participating in those elections. On the basis of that statute, the plaintiff was prevented from voting. The complaint sought $5,000 in damages. The Court held that the plaintiff could recover for the violation of his fourteenth amendment rights.[26] Justice Holmes, writing for the majority, explained "that private damage may be caused by such political action and may be recovered for in a suit at law [has] hardly . . . been doubted for over two hundred years . . ."[27]

Although the nature of the injury *was not* discussed by the Supreme Court, it is important to examine the distinction between the injury caused by a denial of voting rights and a denial of procedural due process. The former involves the deprivation of an intangible political right guaranteed to citizens. The right to participate in the political process is a fundamental guarantee and is cherished as a vested interest by the nation's citizens. The latter is an arbitrary invasion upon an individual's life, liberty, or property. The injury suffered by the denial of procedural due process is the actual loss of life, liberty or property which results from the wrongful invasion. Thus, when one is denied the right to vote,

24 One concern of the Court of Appeals was the possibility in *Piphus,* that the plaintiffs would be precluded from recovery for their individualized injury even if such could be shown. It has been held that in order to recover for individualized injury from the deprivation of procedural due process there must be a showing of "causation in fact." Hilliard v. Williams, 516 F.2d 1344 (6th Cir. 1975), *cert. denied,* 423 U.S. 1066 (1976).

25 273 U.S. 536 (1927).

26 *Id.* at 541. The Court held that the plaintiff's rights were violated under the fourteenth amendment instead of the fifteenth amendment even though it is the fifteenth that deals specifically with voting rights. The Court saw the problem as a matter of racial discrimination, and it believed that the fourteenth amendment was passed "with a special intent to protect blacks from discrimination. . . ." 273 U.S. at 541.

27 *Id.* at 540.

that denial *itself* constitutes the actual injury. In contrast, when one is denied procedural due process the actual injury is found in the deprivation of life, liberty or property, the extent of which is yet to be established.

Nixon v. Herndon[28] is the only Supreme Court decision on the recovery of compensatory damages for a constitutional violation. It is important to note that the Court's holding was limited to the context of voting rights. Although the Circuit Courts of Appeals have addressed the question of compensatory recovery for other constitutional violations, their responses have varied. This variance is due, generally, to a failure to examine the nature of the individual constitutional right.

IV. Circuit Courts of Appeals and Damage Recovery

Among the various courts of appeals no consensus has been reached. The courts have taken different approaches to the issue of whether compensatory damages are recoverable for the violation of constitutional rights. Three basic positions have been adopted in the Courts of Appeals. The first position, which is held by the Seventh Circuit alone, allows the recovery of compensatory damages merely for the technical violation of any constitutional right. At the other extreme are those courts that refuse recovery for the violation of any technical right unless actual damages beyond the constitutional deprivation can be shown to have resulted therefrom. The third position is a more elusive one: damages can be awarded for the deprivation of an intangible civil right, but they cannot be awarded for the technical violation of a constitutional right alone. This third position suggests an analytical method for determining when compensatory damages will be awarded merely upon a showing that the constitutional right was violated. That is, such an analysis would resolve the question of when compensatory damages can be recovered by an individual who has not shown any individualized injury.

In its approach, the Seventh Circuit allows the recovery of compensatory damages for technical violations of constitutional rights. *Piphus v. Carey* is thus unique in allowing recovery for the deprivation of procedural due process without showing any particularized injury.

The Second, Third and Tenth Circuits have expressly denied recovery in the absence of such a showing. In *Stolberg v. Members of Board of Trustees for State Colleges of State of Connecticut*,[29] for example, the plaintiff was dismissed from his position by the defendant board members on grounds later found to be violative of his first amendment rights. The Second Circuit held that the plaintiff's recovery of compensatory damages would be limited to actual pecuniary loss.[30] It was not enough that the plaintiff established an infringement upon his first amendment rights. In order to recover compensatory damages it was necessary for him to show the actual extent of the loss suffered.[31]

28 273 U.S. 536 (1927).
29 474 F.2d 485 (2d Cir. 1973).
30 *Id.* at 488.
31 In an analogous case arising under 42 U.S.C. § 1982, in which private discrimination in housing was alleged, the Second Circuit also held that no compensable damages were recoverable for the "dignitary tort"; it required that actual injury be established. Fort v. White, 530 F.2d 1113 (2d Cir. 1976).

In *United States ex rel. Tyrrell v. Speaker*,[32] the Third Circuit also spoke on the issue of damages for a denial of procedural due process. In that case, an inmate of a state penal institution sought to recover damages from a prison official who had denied the inmate procedural due process by arbitrarily placing him in solitary confinement. The district court awarded the plaintiff prisoner $500 in nominal damages for the denial of his constitutional right. The court of appeals reversed, holding that while nominal damages are recoverable for the deprivation of a constitutional right, an award of $500 is compensatory in nature.[33] Thus compensable injury had to be shown. Furthermore, the court held that in order to recover compensatory damages, actual injury beyond the constitutional violation itself must be shown.[34]

Recovery of compensatory damages for the deprivation of first amendment rights was similarly denied by the Tenth Circuit in *Smith v. Losee*.[35] The plaintiff in that case had been dismissed from his position on the faculty of a Utah state college. The district court found that the dismissal was prompted by the plaintiff's exercise of his first amendment rights.[36] However, the plaintiff was able to find alternative employment at a salary higher than what he had been receiving at the defendant's college. Because there was no pecuniary loss, the Tenth Circuit held that compensatory damages were not recoverable.[37] The court did not consider whether the plaintiff suffered any actual loss, other than pecuniary loss, by the infringement of his first amendment rights.

A more flexible approach has developed in the First Circuit. In *Magnett v. Pelletier*,[38] for example, suit was brought against the defendant police officer for an unreasonable search and seizure. The district court found for the plaintiff and awarded nominal damages of $500 for the deprivation of his rights. The court of appeals reversed the award because, "nominal damages are a mere token, signifying that the plaintiff's rights were technically invaded even though he suffered, or could prove, no loss or damage."[39] Five hundred dollars was more than a token, and thus could not be awarded under the circumstances.

The court, however, did not stop there. On remand the district court was instructed to consider awarding the plaintiff compensatory damages upon a showing of injury in the form of "intangible loss of civil rights or purely mental suf-

32 535 F.2d 823 (3d Cir. 1976).

33 RESTATEMENT OF TORTS § 907 discusses nominal damages as follows: "Nominal damages" are a *trivial sum* of money awarded to a litigant who has established a cause of action but has not established that he is entitled to compensatory damages (emphasis added).

34 *Id.* at 830. In 1975 the Third Circuit discussed the question of awards for damages to students for violations of their first amendment rights. The court said that nominal damages are recoverable for the violation of the right and that compensatory damages may be awarded under certain circumstances for the violation of the right. Paton v. La Prade, 524 F.2d 862 (3d Cir. 1975).

The defendant in the *Paton* case was an FBI agent acting under the authority of his federal position, thus making a cause of action under § 1983 inappropriate because such is restricted to acts committed under the color of state law. A cause of action against federal officials for the violation of constitutional rights was judicially created in the fourth amendment context in Bivens v. Six Unknown Named Agents of Federal Bureau of Narcotics, 403 U.S. 388 (1971).

35 485 F.2d 334 (10th Cir. 1973).

36 *Id.* at 339.

37 *Id.* at 345.

38 488 F.2d 33 (1st Cir. 1973).

39 *Id.* at 35. *See* note 33 *supra* for a discussion of nominal damages.

fering."[40] The court required the plaintiff to show more than a violation of the fourth amendment; it required that the plaintiff come forward and show how he was injured thereby. However, the court recognized that the injury may involve certain intangible deprivations, such as the loss of privacy.

The court in *Magnett* thus distinguished between the violation of the fourth amendment right and the intangible deprivations that may follow therefrom. This distinction between a technical violation of a right and the intangible loss of a civil right is crucial. However, actually making the distinction may be a difficult undertaking. Consider, for instance, two recent cases decided by the First Circuit, *Cordeco Development Corporation v. Vasquez*[41] and *Rivera Morales v. Benitez de Rexach*.[42]

The plaintiff in *Cordeco* claimed that he was deprived of his fourteenth amendment right to equal protection of the law when the defendant delayed issuance of a sand excavation permit to the plaintiff. Political pressure was exerted upon the defendant to withhold the permit.[43] The district court disregarded a recommendation by an advisory jury of an award of $500,000 in compensatory damages because the plaintiff did not suffer any pecuniary loss.[44] The court of appeals affirmed this part of the district court's holding because "the purpose of a damage award is to compensate the injured party for loss resulting from the conduct of the wrongdoer."[45] The loss to be established concerned the plaintiff's interest in the permit. The plaintiff did not show that he was injured by the denial of the permit. It was not necessary, therefore, to award compensatory damages in order to make the plaintiff whole.

The First Circuit in *Rivera Morales* held that compensatory recovery would be allowed for the deprivation of a first amendment right.[46] The plaintiff in that case had been discharged from public employment allegedly on the basis of her political affiliations.[47] The trial judge awarded the plaintiff $10,000 for mental pain and suffering. Despite the finding of the court of appeals that the proof of those injuries was weak, the award was upheld. The court noted that it has "recognized that a plaintiff in a civil rights action who proves only 'an intangible loss of civil rights or purely mental suffering' may be awarded substantial compensatory damages."[48] It was not necessary for the plaintiff to show pecuniary loss resulting from the constitutional deprivation.

The first circuit did not distinguish between the plaintiff in *Rivera Morales* and the plaintiff in *Cordeco*. Both cases involved constitutional violations. The first amendment and the fourteenth amendment were violated respectively. A distinction is found, however, when the precise nature of these constitutional

40 *Id.*
41 539 F.2d 256 (1st Cir.), *cert. denied,* 429 U.S. 978 (1976).
42 541 F.2d 882 (1st Cir. 1976).
43 539 F.2d at 259.
44 *Id.* at 260-61.
45 *Id.* at 262. The court analogized the wrong done in this case to tortious interference with business relations where the plaintiff must show lost profits in order to recover damages.
46 541 F.2d at 886.
47 *Id.* at 885. In Elrod v. Burns, 427 U.S. 347 (1976), the Supreme Court held that the dismissal of a public employee because of his political affiliations was an infringement on his first amendment right to free speech and association unless it furthers a vital government end, e.g., where there is a need for political loyalty in policymaking decisions.
48 541 F.2d at 886.

rights and the corresponding protected interests are examined. This method of analysis clarifies the issue raised in *Piphus v. Carey:* May a student who has been denied procedural due process recover compensatory damages without showing any individualized injury?

V. Focus Upon the Interest Protected

In determining whether compensatory damages should be recovered for the mere violation of a constitutional right, it is necessary to focus upon the nature of the individual constitutional right. Basically, constitutional violations can be placed into two categories. First, there are those violations which necessarily cause a deprivation of a civil or political right when the violation takes place. The violation itself constitutes an infringement upon the interest protected by the constitutional guarantee. The second category includes those rights which when violated constitute the mere breach of a duty. The constitutional guarantee constitutes a means to protect a given end or interest. Any compensable injury suffered by the individual is based on the invasion upon the interest protected. It is, therefore, necessary to focus upon the constitutional right, the interest it seeks to protect, and the point at which there is an infringement upon that interest.

The voting rights cases present the best illustration of the first category of constitutional violations in which an individual is deprived of an intangible political interest when the right is violated. The Constitution guarantees to an individual the right to vote.[49] It is evident that the interest intended to be protected under the applicable constitutional decree is an individual's right to participate in the political process. When such a constitutional right is violated *the injury has occurred.* Thus, in *Nixon v. Herndon*[50] the Supreme Court allowed the recovery of damages for the deprivation of the right to vote. The injury involved was intangible. However, it did constitute the deprivation of a valuable interest. When the right to vote is violated there is an infringement upon the protected interest, and injury is suffered. In a 1919 court of appeals case it was held that "in the eyes of the law this right [to vote] is so valuable that damages are presumed from the wrongful deprivation of it without evidence of actual loss of money, property, or any other valuable thing . . ."[51] Unless timely injunctive or declaratory relief is available, compensable injury has taken place, and damages should be awarded.[52]

The guarantee of procedural due process is distinguishable from the right to vote. The former involves the constitutional *duty* to provide a hearing in order to prevent arbitrary and wrongful deprivations of "life, liberty or property." Procedural due process represents a means to an end, that end being the protection of an individual's interest in life, liberty and property. Indeed, in determining whether an individual is entitled to procedural due process, the Supreme Court

49 *See* U.S. CONST. amends. XV, XVII, XIX, XXIV, and XXVI.
50 273 U.S. 536 (1927).
51 Wayne v. Venable, 260 F. 64, 66 (8th Cir. 1919).
52 Similarly, a violation of the first amendment right of free association, as found in *Rivera Morales,* can in itself constitute a valuable deprivation. Among other things, such a violation constrains "the individual's ability to act according to his beliefs and to associate with others of his political persuasion. . . ." Elrod v. Burns, 427 U.S. 347, 355-56 (1976).

has focused upon "the *nature* of the interest at stake."[53] The right to procedural due process does not exist in a vacuum but only where there is a protectible interest.[54]

For instance, in *Board of Regents v. Roth*[55] a non-tenured assistant professor's yearly contract was not renewed, and no hearing was provided in order to ascertain the reasons for the termination of his employment. The Supreme Court held that a hearing need not be provided because the plaintiff did not have a sufficient *property* interest.[56] It was pointed out by the Court that "the Fourteenth Amendment's procedural protection of property is a safeguard of the security interests that a person has already acquired in specific benefits."[57] It was found that the plaintiff had not acquired a sufficient *property* interest because there was no actual claim to entitlement.[58] The plaintiff's contract had expired, and he was not entitled to renewal.

In *Piphus v. Carey* the Seventh Circuit was confronted with a case involving the suspension of a public school student without procedural due process. The Piphus case followed the Supreme Court ruling in *Goss v. Lopez*[59] that public school students facing suspension have a right to a hearing under the Due Process Clause of the fourteenth amendment. It was held by the Court that the Due Process Clause was triggered because of the "student's legitimate entitlement to a public education as a property interest . . ."[60]

The Seventh Circuit failed to examine the nature of the right to procedural due process and the interests protected thereby. Such an examination would have revealed that when a student is suspended without due process, it is the deprivation of his property interest that constitutes the injury. No injury is suffered when a mere technical violation of procedural due process occurs. Rather, injury occurs through the deprivation of life, liberty or property; this specific deprivation should be shown in order to recover compensatory damages. The mere denial of procedural due process does not, of itself, create a need for compensatory damages. A student could be "made whole" in that respect by providing declaratory or injunctive relief which would effectively provide the student with the procedure due him.

Thus, in order to recover compensatory damages a student should be required to show individualized injury. A student must establish how he has been deprived of life, liberty, or property because that is where any compensable injury lies.[61]

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53 Board of Regents v. Roth, 408 U.S. 564, 571 (1972).
54 The protectible interest may, of course, be an intangible one.
55 408 U.S. 564 (1972).
56 *Id.* at 578.
57 *Id.* at 576.
58 *Id.* at 578.
59 419 U.S. 565 (1975).
60 *Id.* at 574.
61 It is important to note that even if the plaintiffs were unable to show compensable injury they would not be economically precluded from vindicating their constitutional rights. Attorney's fees may be recovered by the plaintiffs. The Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988, allows the court in its discretion to award reasonable attorney's fees in civil rights cases, including those brought under § 1983.

The recovery of attorney's fees in civil rights action had been limited by the Supreme Court in Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240 (1975). The Civil

VI. Conclusion

Silas Brisco and Jarius Piphus were found to have been suspended from school without having been afforded procedural due process as required by the fourteenth amendment to the Constitution. The United States Court of Appeals for the Seventh Circuit held that it was not necessary for Brisco and Piphus to show how they were individually injured thereby in order to recover compensatory damages. This conclusion by the court is misplaced because it failed to examine the nature of the constitutional right and the interests involved therein. Reliance by the court upon the voting rights decision was inappropriate without such an examination.

Procedural due process, unlike the right to vote, represents a means to an end as opposed to an end itself. The violation of the procedural due process does not necessarily constitute a deprivation of the protected interests. An individual should come forward and show how he has been injured by the violation of the right before compensatory damages can be recovered.

Nevertheless, the Seventh Circuit in *Piphus v. Carey* held that compensatory damages could be recovered for the violation of procedural due process simply on the basis of the "injury which is 'inherent in the nature of the wrong.' "[62] The Court reached this holding without examining the nature of the right to procedural due process. This examination would have revealed that the right to procedural due process seeks to protect life, liberty and property and that compensable injury lies in the deprivation of those protected interests. The denial of the hearing itself does not constitute the injury.

In its October 1977 term, the United States Supreme Court will review the Seventh Circuit's decision in *Piphus*.[63] At that time the Court should examine the nature of the right to procedural due process and ascertain the interests protected thereby. Such an examination will reveal that the Seventh Circuit did not adequately analyze the issues involved. In the course of reversing *Piphus*, the Supreme Court should reject the Seventh Circuit's simplistic analysis and recognize the differences among the various constitutional rights. This would provide a more perceptive approach to compensatory damage claims for procedural due process violations.

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Rights Attorney's Fees Awards Act was passed in response to the *Alyeska* case. [1976] U.S. CODE CONG. & AD. NEWS at 5909.

Even though this attorney's fees act was enacted after the district court's decision in Piphus v. Carey, there could still have been an award of attorney's fees. The Supreme Court has given retroactive effect to the act for at least those cases that are still in the appellate process. Stanton v. Bond, 429 U.S. 973 (1977).

Thus, the plaintiffs in Piphus v. Carey would not be without a remedy technically or practically.

62 545 F.2d at 31.

63 Carey v. Piphus, *cert. granted*, 430 U.S. 964 (1977).

CIVIL RIGHTS—ALLEGED RACIAL DISCRIMINATION IN MUNICIPAL ZONING POLICIES—A VIOLATION OF THE FAIR HOUSING ACT CAN BE ESTABLISHED BY A SHOWING OF DISCRIMINATORY EFFECT WITHOUT A SHOWING OF DISCRIMINATORY INTENT.

*Metropolitan Housing Development Corp. v. Village of Arlington Heights**

I. Introduction

Arlington Heights v. Metropolitan Housing Development Corp., decided by the Seventh Circuit on July 7, 1977, involves alleged discrimination in municipal zoning policies. The case was decided in the wake of the recent landmark decision of the Supreme Court in *Washington v. Davis*[1] which significantly affects claims of racial discrimination by requiring a showing of intent as a precondition for obtaining constitutionally based relief. *Davis* clearly distinguished standards under Title VII of the Civil Rights Act of 1964[2] from constitutional standards under the equal protection clause of the fourteenth amendment, holding that the former are not applicable where relief is sought on constitutional grounds.

Arlington Heights represents an attempt by the Seventh Circuit to reconcile these apparently mutually exclusive standards.

The decision invites criticism as an infringement of the power of a municipality to promulgate and implement zoning ordinances within its boundaries. More importantly, the decision represents a major departure from the clearly enunciated constitutional standard in *Davis*. Whether or not the Seventh Circuit's decision is allowed to stand, the ramifications in the area of housing—both private and public—will be great.

Metropolitan Housing Development Corp. (MHDC), a non-profit developer, contracted to purchase a tract within the boundaries of the Village of Arlington Heights (Village) in order to build low and moderate income housing. The contract was contingent upon securing a zoning variance as well as federal housing assistance. MHDC applied to the Village for the necessary rezoning from a single-family to a multiple-family classification. At a series of Village Plan Commission public meetings, both supporters and opponents recognized that the project would probably be racially integrated. Opponents stressed that the site had always been zoned single-family, and that the Village's apartment policy called for limited use of multiple-family zoning, primarily to serve as a buffer between single-family development and commercial or manufacturing districts. After the Village had denied the rezoning application, MHDC, along with three black residents, filed suit for injunctive and declaratory relief, alleging that the denial was racially discriminatory and violated, *inter alia,* the equal protection clause of the fourteenth amendment and the Fair Housing Act of 1968.[3]

* 558 F.2d 1283 (7th Cir. 1977).
1 426 U.S. 229 (1976).
2 42 U.S.C. § 2000e (1964).
3 42 U.S.C. § 3601 (1968).

The district court held that the Village's rezoning denial was motivated not by racial discrimination but by a desire to protect property values and maintain the Village's zoning plan.[4] The Court of Appeals for the Seventh Circuit affirmed those conclusions, but reversed on the grounds that the "ultimate effect" of the rezoning denial was racially discriminatory. It observed that the denial would disproportionately affect blacks, in that the general suburban area, though economically expanding, would continue to be marked by residential segregation.[5]

The United States Supreme Court reversed, stating that proof of racially discriminatory intent or purpose is required to show a violation of the equal protection clause.[6] Since the Seventh Circuit had affirmed the district court's finding that there was no discriminatory purpose behind the Village's refusal to rezone, the Supreme Court held that MHDC had suffered no deprivation of its constitutional rights.[7] The Court then remanded the case for a determination of whether the Village's conduct violated the Fair Housing Act.

On remand, the Seventh Circuit held that under the circumstances of the case the Village had a statutory obligation under the Fair Housing Act to refrain from zoning policies that effectively foreclosed the construction of any low-cost housing within its corporate boundaries. The Seventh Circuit then remanded the case to the district court for a determination of whether the Village's zoning decision was in violation of the Fair Housing Act.[8]

The basic issue addressed by the Seventh Circuit on remand was whether the Village's refusal to rezone violated § 3604(a)[9] or § 3617[10] of the Fair Housing Act. The pivotal question was whether such a violation could be shown on the basis of discriminatory *effect* without any showing of discriminatory intent. The recent Supreme Court decision in *Washington v. Davis*[11] held that a violation of the equal protection clause of the fourteenth amendment could not be established in the absence of a showing of intent to discriminate. In deciding *Arlington Heights* on remand, the Seventh Circuit was in effect deciding whether the requisite showing of intent espoused in *Davis* was applicable to the Fair Housing Act.

II. Circumventing the Intent Requirement of *Washington v. Davis*

A. *Scope of the Intent Requirement*

The recent decision of the Supreme Court in *Washington v. Davis* estab-

4 373 F.Supp. 208, 211 (N.D. Ill. 1974).
5 517 F.2d 409, 414 (7th Cir. 1975).
6 429 U.S. 552 (1977).
7 *Id.* at 566.
8 558 F.2d 1283 (1977).
9 Section 3604(a) provides: "As made applicable by section 3603 of this title and except as exempted by sections 3603(b) and 3607 of this title, it shall be unlawful—
(a) To refuse to sell or rent after the making of a bona fide offer, or to refuse to negotiate for the sale or rental of, or otherwise make unavailable or deny, a dwelling to any person *because* of race, color, religion, sex, or national origin."
10 Section 3617 provides: "It shall be unlawful to coerce, intimidate, threaten or interfere with any person in the exercise or enjoyment of, or on account of his having exercised or enjoyed, or on account of his having aided or encouraged any other person in the exercise or enjoyment of, any right granted or protected by sections 3603, 3605, or 3606 of this title."
11 426 U.S. at 242.

lished that a showing of discriminatory intent is a prerequisite to a finding of racial discrimination under the fourteenth amendment.[12] *Davis* involved allegations of discrimination in federal employment. A far greater proportion of blacks than whites—four times as many—failed a test administered by the District of Columbia Police Department. The District of Columbia Court of Appeals held that this disproportionate impact, standing alone and without regard to whether it indicated a discriminatory purpose, was sufficient to establish a constitutional violation. The Supreme Court reversed,[13] holding that proof of racially discriminatory intent or purpose is required to show a violation of the equal protection clause. In so doing the Court rejected the court of appeals' application of Title VII standards,[14] and declined to hold that the constitutional standard for adjudicating claims of invidious racial discrimination is identical to the standard applicable under Title VII.

In *Arlington Heights* the Seventh Circuit's decision on remand focused on whether the intent requirement of *Washington v. Davis* extends to claims of racial discrimination under the Fair Housing Act. In determining whether the Village's refusal to rezone violated the Act, the Seventh Circuit narrowed the question to whether the refusal to rezone made unavailable or denied a dwelling to any person "because of race" within the meaning of § 3604(a). As the court itself pointed out, "the major obstacle to concluding that action taken without discriminatory intent can violate § 3604(a) is the phrase 'because of race' contained in the statutory provision."[15]

In attempting to overcome this obstacle, the Seventh Circuit relied on policy, analogy, and semantics. Rejecting the narrow view of the phrase "because of race"[16] adopted by the Supreme Court in *Davis,* the Seventh Circuit accepted the broad view that an act is committed "because of race" whenever the natural and foreseeable consequence of that act is to discriminate between races, regardless of intent.[17] After analogizing to Title VII of the Civil Rights Act of 1964[18] and discussing national housing policy, the court concluded that a violation of § 3604(a) can be established by a showing of discriminatory effect without a showing of discriminatory intent. A more rigorous standard was thus established for evaluating alleged violations of the Fair Housing Act. The adoption of this new standard[19] allowed the court to avoid application of the

12 *Id.* at 239.
13 *Id.* at 237.
14 *See, e.g.,* Griggs v. Duke Power Co., 401 U.S. 424 (1971).
15 558 F.2d 1283, 1288 (7th Cir. 1977).
16 The narrow view of the phrase is that a party cannot commit an act "because of race" unless he intends to discriminate between races.
17 558 F.2d 1283, 1288 (7th Cir. 1977).
18 42 U.S.C. § 2000e.
19 The appellate court sets forth four factors which serve as the criteria for determining under what circumstances effect without intent will violate section 3604(a). They are: (1) how strong is the plaintiff's showing of discriminatory effect; (2) whether there is some evidence of discriminatory intent, thought not enough to satisfy the constitutional standard of Washington v. Davis; (3) what is the defendant's interest in taking the action complained of; and (4) does the plaintiff seek to compel the defendant to affirmatively provide housing for members of minority groups or merely to restrain the defendant from interfering with individual property owners who wish to provide such housing.

An analysis of these factors shows that: (1) the class disadvantaged by the Village's action was not predominately nonwhite, because 60% of the people in the Chicago area eligible for federal housing subsidization in 1970 were white; (2) there was no evidence of discrimina-

Davis standard and, as a result, enabled the court to reach the issue of alleged discrimination.

The violation alleged in *Arlington Heights* turns on the issue of racial discrimination. The basis of a discrimination claim is some violation of the right to equal protection of the laws. Thus, the fact that the alleged discrimination occurred in the context of housing is not determinative since the claim of discrimination must stem from the United States Constitution and 42 U.S.C. §§ 1981, 1982, 1983.[20] A violation of the Fair Housing Act based on racial discrimination cannot, therefore, be established independent of the fourteenth amendment.

This relationship was recognized in *Banks v. Park*,[21] a district court case involving alleged discrimination in the revocation of building permits which would have allowed low-income housing to be built in the white area of Cleveland. The district court asserted that:

> *The revocation of the building permits for the [sites involved] constitutes a violation of 42 U.S.C. §§ 1981, 1983, 2000d, and 3601 et seq. in that it denies the Negro plaintiffs equal protection of the laws,* subjects them to discrimination on grounds of race or color in the federally assisted public housing program and deprives them of the right to equal access to housing on a non-discriminatory basis. . . .[22] The Fair Housing Act of 1968, 42 U.S.C. § 3604 et seq. in establishing a national policy of fair housing throughout the United States carried with it the clear implication local housing authorities in conjunction with Federal agencies responsible for housing programs are to affirmatively institute action the result of which was to be the implementation of the dual and mutual goal of fair housing and the elimination of discrimination in that housing [citations omitted]. Therefore, *the failure of the housing authority to include any racial criteria in determining site selection constitutes a violation of the Fourteenth Amendment.*[23] (emphasis added)

B. *Analogy to Title VII*

In setting forth its new independent statutory standard, the Seventh Circuit relied heavily on Title VII of the Civil Rights Act of 1964, which allows a prima facie case of employment discrimination to be established by statistical evidence of discriminatory impact, without a showing of discriminatory intent. While the fundamental issue of discrimination may be common to both Title VII cases and Fair Housing Act cases, that fact alone does not warrant the ap-

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tory intent in this case; (3) the Village was acting within the scope of the authority to zone granted to it by Illinois law; and (4) the Court of Appeals finds no affirmative duty being imposed on the Village.

Though failing to meet two of its criteria completely (no evidence of discriminatory intent and the legitimate exercise of municipal authority in zoning), the Seventh Circuit nevertheless held that under these circumstances effect alone would establish a violation of 42 U.S.C. § 3604(a). The court's conclusion is further weakened by the fact that its first criterion for a finding of discrimination is not completely met either, since the class disadvantaged by the Village's decision was *not* predominantly nonwhite.

20 Johnson v. Hoffman, 424 F.Supp. 490, 493 (E.D. Mo. 1977).

21 341 F.Supp. 1175 (N.D. Ohio 1972).

22 *Id.* at 1179.

23 *Id.* at 1182.

plication of Title VII standards to Fair Housing Act cases. This was made clear by the Supreme Court in *Washington v. Davis,* where the Court specifically limited the applicability of Title VII standards to the employment context, saying:

> A rule that a statute designed to serve neutral ends is nevertheless invalid, absent compelling justification, if in practice it benefits or burdens one race more than another would be far reaching and would raise serious questions about, and perhaps invalidate, a whole range of tax, welfare, public service, regulatory, and licensing statutes that may be more burdensome to the poor and to the average black than to the more affluent white. Given that rule, such consequences would perhaps be likely to follow. However, in our view, extension of the rule beyond those areas where it is already applicable by reason of statute, such as in the field of public employment, should await legislative prescription.[24]

In *Arlington Heights* the Seventh Circuit effectively extended Title VII standards into the housing area without the requisite legislative prescription mandated by the Supreme Court in *Davis.* Title VII, and the regulations promulgated under it, were designed specifically for application in the context of employment. Sections 2000e-2 and 2000e-3 identify unlawful employment practices. Section 2000e-4 establishes the Equal Employment Opportunity Commission and § 2000e-5 empowers the Commission to enforce the provisions of Title VII.

The specificity of Title VII is not paralleled by comparable provisions in the Fair Housing Act. Most significantly, the Fair Housing Act does not provide for the crucial enforcement power allocated to the EEOC under Title VII. The regulations, tests, and guidelines administered by the EEOC are tailored to the prevention and elimination of unlawful employment practices. Comparable enforcement provisions for the Fair Housing Act would aid implementation of the Act and promote the goals of national housing policy. However, in the absence of such legislative guidelines, the Seventh Circuit acted improperly in extending the broad standards of Title VII to its Fair Housing Act analysis in *Arlington Heights.* The Seventh Circuit attempted to support its application of Title VII standards to the Fair Housing Act with arguments based on national housing policy. As a result, the civil rights objectives of the Fair Housing Act became the focus of the court's argument.

III. Policies in Conflict: Autonomy of Municipal Zoning Powers and National Civil Rights Objectives

A. *Fair Housing Policy*

The Seventh Circuit marshalled legislative history and subsequent interpretations of the Fair Housing Act to support its finding of racial discrimination. The major problem with the court's policy analysis is that it focuses on the public housing problem to the complete exclusion of the zoning issue, and thereby ignores established precedent in the law of zoning.

24 426 U.S. at 248.

The Fair Housing Act was enacted "to provide, within constitutional limitations, for fair housing throughout the United States."[25] The language of the Act is as broad[26] as its asserted goal of integrated housing. The Act is clearly intended to improve housing conditions. The question arises not as to intention, but rather as to the implementation of the Act. The Seventh Circuit in *Arlington Heights* endorsed an interpretation of the Act which imposes an affirmative duty on a municipality to promote integrated housing. This affirmative duty is based on the language in § 3608 of the Fair Housing Act.[27]

Reference to this same language was made in *Otero v. New York City Housing Authority,*[28] where the Second Circuit recognized that there is an affirmative duty to *administer* existing programs and activities so as to promote integration in housing. This affirmative duty, however, couched in administrative terms, is readily distinguishable from the affirmative duty to actively promote integration imposed on the Village by the Seventh Circuit in *Arlington Heights.* This distinction was expressly made in *Acevedo v. Nassau County, New York,*[29] a case decided by the Second Circuit after its decision in *Otero.* As a result, the existence of any such duty under the Fair Housing Act was unequivocally denied.

In *Acevedo,* Nassau County had purchased land and proposed a plan to build low-income housing on the site. Public opposition to the plan caused the County to abandon the project and use the land for other types of development. Affirming a decision in favor of the County, the appellate court said:

> The Fair Housing Act does not impose any duty upon a governmental body to construct or to *"plan for, approve and promote" any housing* . . . All of the cases on which appellants rely involve either the refusal of a governmental body to grant benefits equally to all, or the governmental obstruction of private projects beneficial to minority groups or integration. Here appellants seek not to remove governmental obstacles to proposed housing but rather to impose on appellees an affirmative duty to construct housing. This is clearly not required by any provision of the Constitution.[30] (emphasis added)

National housing policy has also emerged from sources other than the Fair Housing Act. For example, public housing decisions have been upheld on the basis of the police power.[31] *Berman v. Parker*[32] involved a District of Columbia decision to implement a redevelopment project which necessitated governmental taking of the property of low-income slum dwellers. The Supreme Court allowed the action, deferring to the role of the legislature in the area of social legislation.[33]

25 42 U.S.C. § 3601.
26 Trafficante v. Metropolitan Life Insurance Company, 409 U.S. 205 (1972).
27 42 U.S.C. § 3608(d) provides that the Secretary of Housing and Urban Development shall "administer the programs and activities relating to housing and urban development in a manner affirmatively to further the policies of this sub-chapter."
28 484 F.2d 1112 (2d Cir. 1973). The equal protection clause was also given as a reason for the affirmative duty.
29 500 F.2d 1078 (2d Cir. 1974).
30 *Id.* at 1081.
31 Zoning as an exercise of police power will be considered later in the comment.
32 348 U.S. 26 (1954).
33 *Id.* at 32.

The Court asserted that it does "not sit to determine whether a particular project is or is not desirable."[34]

Another example of Supreme Court recognition of legislative power in this area is contained in *James v. Valtierra*,[35] where the Supreme Court upheld a California law providing that no low-rent housing project could be developed, constructed, or acquired by any state public body without the approval of a majority of those voting at a community election. Commenting on this referendum procedure, the Supreme Court said:

> This procedure ensures that all the people of a community will have a voice in a decision which may lead to large expenditures of local governmental funds for increased public services and to lower tax revenues. It gives them a voice in decisions that will affect the future development of their own community.[36]

The Supreme Court also addressed the role of the legislature in determining housing policy in *Lindsey v. Normet*[37] as part of its discussion of the Oregon Forcible Entry and Wrongful Detainer Statute. The Court asserted that:

> We do not denigrate the importance of decent, safe, and sanitary housing. But the Constitution does not provide judicial remedies for every social and economic ill. We are unable to perceive in that document any constitutional guarantee of access to dwellings of a particular quality. . . . Absent constitutional mandate, the assurance of adequate housing and the definition of landlord-tenant relationships are legislative, not judicial functions.[38]

Although the Constitution does not expressly deal with housing, the most significant influence on national housing policy has been the equal protection clause of the fourteenth amendment. Various discriminatory housing practices have been outlawed by judicial decree as violative of the equal protection clause. For example, in *Gautreaux v. City of Chicago*,[39] the Seventh Circuit relied on the fourteenth amendment in concluding that the Chicago City Council had acted with racial motivation in failing to enable the construction of low-income housing in white areas of the city.

> It has long been conclusively established in this case (1) that "plaintiffs, as present and future users of the system, have the right under the Fourteenth Amendment to have sites selected for public housing projects without regard to the racial composition of either the surrounding neighborhood or of the projects themselves," (2) that CHA [Chicago Housing Authority] had violated the Fourteenth Amendment by intentionally choosing sites for family public housing and adopting tenant assignment procedures for the purpose of maintaining existing patterns of residential separation of races, and (3) that HUD had violated the due process clause of the Fifth Amendment by its knowing acquiescence in CHA's discriminatory housing program.[40]

34 *Id.* at 33.
35 402 U.S. 137 (1971).
36 *Id.* at 143.
37 405 U.S. 56 (1972).
38 *Id.* at 74.
39 480 F.2d 210 (7th Cir. 1973).
40 *Id.* at 212.

The pervasive influence of the fourteenth amendment in the housing area can also be noted in the extensive treatment of the subject in legal literature.[41] A general discussion of the various applications of the fourteenth amendment is not within the scope of this comment. However, relevant aspects of the constitutional argument will be discussed in connection with the following analysis of zoning power.

B. *The Power to Zone*

The Supreme Court decision in *Arlington Heights* is significant because it is a manifestation of what appears to be a new Supreme Court interest in the zoning area. Zoning policy was initially established in the landmark case of *Village of Euclid v. Ambler Realty Company,*[42] and clarified in *Nectow v. City of Cambridge.*[43] After the *Nectow* decision in 1928, however, the Supreme Court refused to hear any zoning cases until 1974, when a decision was handed down in *Village of Belle Terre v. Boraas.*[44] The *Belle Terre* decision was followed by two zoning decisions in 1977—*Arlington Heights* and *Moore v. City of East Cleveland.*[45]

Euclid v. Ambler Realty Company involved a situation quite similar to that in *Arlington Heights.* The zoning ordinance challenged in the *Euclid* case prohibited certain portions of property from being sold for industrial purposes. The value of the land was thus greatly reduced and the property owner attacked the ordinance on the grounds that it violated the fourteenth amendment because it deprived him of liberty and property without due process of law and denied him the equal protection of the law.[46] The Supreme Court upheld the ordinance as the product of a "municipality, with powers of its own and authority to govern itself as it sees fit within the limits of the organic law of its creation and State and Federal Constitutions. . . ."[47] The Court concluded that "if the validity of the legislative classification for zoning purposes be fairly debatable, the legislative judgment must be allowed to control."[48] The Court stated that before a zoning ordinance would be declared unconstitutional, it must be shown to be clearly arbitrary and unreasonable, having no substantial relation to public health, safety, morals, or general welfare.[49]

The test of constitutionality set forth in *Euclid* was applied in *Nectow v. City of Cambridge. Nectow* involved the inclusion of private land in a residential district under a zoning ordinance containing restrictions concerning the use of business and industrial buildings. Enforcement of the ordinance resulted in serious damage to the owner. The Supreme Court struck down the ordinance as violative of the fourteenth amendment, holding that the health, safety, con-

41 *See, e.g.,* 16 ARIZ. L. REV. 439-64 (1974); 4 FORDHAM URBAN L.J. 147-65 (1975); 7 LOYOLA U.L.J. (Chicago) 141-58 (1976); 43 TENN. L. REV. 133-47 (1975).
42 272 U.S. 365 (1926).
43 277 U.S. 183 (1928).
44 416 U.S. 1 (1974).
45 45 U.S.L.W. 4550 (1977).
46 272 U.S. at 384.
47 *Id.* at 389.
48 *Id.* at 388.
49 272 U.S. at 395.

venience and general welfare of the part of the city affected would not be promoted by the ordinance.[50]

The *Euclid* test was applied by the Supreme Court once again in *Village of Belle Terre v. Boraas,* a case which in many ways previewed the basic issues involved in *Arlington Heights.* In *Belle Terre,* the Supreme Court upheld a zoning ordinance designed to limit the number of unmarried people residing in one house. Discrimination arguments were urged on the basis of the fourteenth amendment, but the Court found the arguments unpersuasive. The ordinance was sustained on the grounds that it bore a rational relationship to a permissible state objective. As noted by the Court:

> We deal with economic and social legislation where legislatures have historically drawn lines which we respect against the charge of violation of the Equal Protection Clause if the law be reasonable, not arbitrary and bears a rational relationship to a permissible state objective.[51]

Although in dissent, Justice Marshall reiterated the majority's recognition of local zoning power:

> Local zoning authorities may properly act in furtherance of the objectives asserted to be served by the ordinance at issue here: restricting uncontrolled growth, solving traffic problems, keeping rental costs at a reasonable level, and making the community attractive to families. The police power which provides the justification for zoning is not narrowly confined. And, it is appropriate that we afford zoning authorities considerable latitude in choosing the means by which to implement such purposes.[52]

In *Arlington Heights* the Supreme Court addressed the zoning aspects of the case only to the extent necessary to a determination of intent under *Washington v. Davis.* The decision is significant because it narrows the constitutional standard under which relief in zoning cases will be granted. In order to secure relief under the equal protection clause, it will now be necessary to meet the test set out in *Euclid* as well as the intent requirement of *Washington v. Davis.* However, the intent requirement does not apply to zoning cases decided on due process grounds, such as *Moore v. City of East Cleveland.*

In *Moore v. City of East Cleveland,* the Supreme Court relied on the due process clause of the fourteenth amendment to invalidate a housing ordinance which limited the occupancy of dwelling units in such a way as to make it illegal for certain family members to share a single household. Though the city's zoning ordinance was declared unconstitutional, the Court was not concerned with the zoning aspects of the case. The controlling consideration was the protection of the freedom of personal choice in matters of family life provided by the due process clause.[53]

These Supreme Court zoning decisions recognize and respect the right of municipalities to zone in furtherance of legitimate, local objectives, but at the

50 277 U.S. at 188.
51 416 U.S. at 8.
52 *Id.* at 13-14 (Marshall, J., dissenting).
53 45 U.S.L.W. at 4552.

same time demonstrate that the exercise of this right is at all times subject to limitation by the equal protection[54] and due process clauses of the fourteenth amendment.

54 With the exception of the Eighth Circuit in United States v. City of Black Jack, the circuits which have addressed alleged discrimination in zoning have done so in terms of the Equal Protection Clause. A brief analysis of four representative cases follows:

(1) Southern Alameda Spanish Speaking Organization (SASSO) v. City of Union City, California, 424 F.2d 291 (9th Cir. 1970) upheld a referendum which nullified a city ordinance rezoning a tract of land to a multi-family residential category in order to permit construction of a federally financed project for low- and moderate-income families. In answering SASSO's charge that the referendum and its results infringed upon their constitutional rights under the due process and equal protection clauses of the fourteenth amendment the Court recognized that ". . . many environmental and social values are involved in determinations of land use." As the District Court noted, "There is no more reason to find that the [rejection of zoning] was done on the ground of invidious racial discrimination any more than on perfectly legitimate environmental grounds which are always and necessarily involved in zoning issues." (*Id.* at 295.)

(2) Dailey v. City of Lawton, Oklahoma, 425 F.2d 1037 (10th Cir. 1970) involved an action under 42 U.S.C. § 1983 to enjoin the city from denying building permits for construction of a privately sponsored low-income housing project on grounds of a zoning violation. Basing its holding on the fourteenth amendment, the Court determined that the record supported a finding that the actions of the planning commission and the city council were racially motivated, arbitrary and unreasonable and that injunctive relief was necessary and appropriate to protect the rights of the applicants and prospective tenants.

(3) Kennedy Park Homes Association v. City of Lackawanna, New York, 436 F.2d 108 (2d Cir. 1970), *cert. denied*, 401 U.S. 1010 (1971) held that the City's moratorium on new subdivisions was unconstitutional because it interfered with the developer's right of freedom from discrimination by the States in the enjoyment of property rights. The court found that the events surrounding the moratorium and the subsequent rezoning by the City indicated "state action amounting to specific authorization and continuous encouragement of racial discrimination, if not almost complete racial segregation." (*Id.* at 114.)

(4) Ybarra v. City of Town of Los Altos Hills, 503 F.2d 250 (9th Cir. 1974) upheld a local ordinance which restricted the use of certain property to single dwelling units. Appellants, intending to build a low-income housing project, had obtained an option to buy certain lots affected by the ordinance and the option could only be exercised if the land were rezoned for multi-family dwellings. Addressing the appellants' allegations of constitutional violations, the Court provided a succinct application of the constitutional test: "Since there is no suspect classification requiring a strict standard of review, the town need only show that the ordinance bears a rational relationship to a legitimate governmental interest. Here the ordinance is rationally related to preserving the town's rural environment." (*Id.* at 254.)

Black Jack is the only case, with the exception of *Arlington Heights,* in which a zoning ordinance was struck down as violative of the Fair Housing Act. In 1969, the Inter Religious Center for Urban Affairs obtained an option on land and applied for federal funding to build low-income housing on property then in an unincorporated area. Upon learning that federal funds were reserved for the development, the residents of Black Jack immediately incorporated and passed a zoning ordinance prohibiting the construction of any new multiple-family dwellings. The court found the ordinance invalid as a violation of the Fair Housing Act. The Eighth Circuit's decision goes to great lengths to remove the issue from the constitutional sphere. In note 3, the court says that "the uncontradicted evidence indicates that, at all levels of opposition, race played a significant role, both in the drive to incorporate and the decision to rezone . . . Nevertheless, we do not base our conclusion that the Black Jack ordinance violates Title VIII [Fair Housing Act] on a finding that there was an improper purpose." (*Id.* at 1185.) However, the court goes on to arrive at its decision by applying standards virtually identical to those applied in a constitutional context, especially the determination that effect alone would create a prima facie case of racial discrimination in housing. Discussing the standard, the court continued: "The requirement that a governmental defendant demonstrate that its conduct is necessary to further a compelling governmental interest is most often expressed in cases involving equal protection challenges to statutes or ordinances creating 'suspect classifications' (citations omitted). Even though this case is based on a federal statute, rather than on the Fourteenth Amendment, we believe that, once the United States established a prima facie case of racial discrimination, it became proper to apply the compelling governmental interest requirement of the equal protection cases." (*Id.* at 1185.) The court was obviously concerned about the implications of the *Belle Terre* decision: "The discretion of local zoning officials, recently recognized in Village of Belle Terre v. Boraas [citations omitted] must be curbed where the clear result of such discretion is the segregation of low income blacks from all white neighborhoods." Banks v. Park (citations omitted). Unsure of how constitutional developments in the zoning area might affect its decision, the court may have taken great pains to use arguments not dependent on some constitutional support in the

The Seventh Circuit did not believe that these constitutional safeguards were adequate to combat the threat of discrimination in the Village's zoning policy. By rejecting the Supreme Court's standard in *Davis* and establishing its own standard, the court was able to achieve on statutory grounds what could not be achieved by reliance on the fourteenth amendment.

The elimination of discrimination in housing is clearly an important part of the policy behind the Fair Housing Act. The Seventh Circuit attempts to expand the Act to promote the desired goal of equality in housing. The new standards enunciated by the Seventh Circuit are intended to effect the elimination of discrimination in local zoning policy. The court's concern with discrimination was the basis of its first *Arlington Heights* decision, and remains the controlling consideration on remand. The difficulty with the Seventh Circuit's decision is not the court's recognition of the civil rights objectives of national housing policy, but rather its rejection of the applicable constitutional standard in the pursuit of those objectives. The appropriate remedy in this case is provided, not by the Fair Housing Act, but rather by the equal protection clause of the fourteenth amendment. Consequently, the framework for analysis on remand should have been the equal protection clause, with its standard clarified by *Washington v. Davis.*

IV. Implications and Projected Impact of *Washington v. Davis*

The *Arlington Heights* controversy is far from settled. There has been no decision as to the validity of the Village zoning ordinance and, in all likelihood, any ultimate decision will be the subject of an appeal.[55] Thus, it is probable that the Supreme Court will again consider *Arlington Heights* on review of the Seventh Circuit's interpretation of the Fair Housing Act. The Court will then have the opportunity conclusively to establish that the intent requirement of *Washington v. Davis* does apply to the Fair Housing Act.

The *Davis* standard has been the determinative factor in an increasing number of decisions,[56] including cases involving alleged racial discrimination. In *Richardson v. McFadden,*[57] for example, four black law students challenged the constitutionality of a state bar examination, alleging that it was applied discriminatorily to black applicants generally because a greater proportion of blacks

nature of the Equal Protection Clause. Retrospectively, the decision in *Arlington Heights* would not have affected the holding in *Black Jack.* The facts of the case make it clear that the *Davis* standard would have been met by the evidence of racially motivated action on the part of Black Jack officials. The existence of independent constitutional grounds for finding a zoning violation distinguished *Black Jack* from *Arlington Heights.* The Seventh Circuit in effect relies on a *Black Jack* argument but does not have the luxury of an improper purpose to "ignore" in arriving at its decision.

55 The case may be moot—the issue would be moot if (1) another parcel of land within Arlington Heights is found which is both properly zoned and suitable for low-cost housing under federal standards, or (2) subsidization could not be secured under section 8 of the United States Housing Act of 1937, 42 U.S.C. § 1437(f) for construction on the Lincoln Green site.

56 *See, e.g.,* United States v. City of Chicago, 549 F.2d 415 (7th Cir. 1977); City of Milwaukee v. Saxbe, 546 F.2d 693 (7th Cir. 1976); Chicano Police Officers Association v. Stover, 552 F.2d 918 (10th Cir. 1977); Firefighters Institute, Etc. v. City of St. Louis, 549 F.2d 506 (8th Cir. 1977); Arthur v. Nyquist, 429 F.Supp. 206 (W.D. N.Y. 1977); Penick v. Columbus Board of Education, 429 F.Supp. 229 (S.D. Ohio 1977).

57 540 F.2d 744 (4th Cir. 1976).

than whites failed to pass the test. The Court relied on *Davis* in holding that disproportionate impact on blacks seeking admission to the bar was not enough by itself to demonstrate racial discrimination.

Grand jury selection procedures were challenged on similar grounds in *Casteneda v. Partida.*[58] In deciding the case the Supreme Court referred to both *Davis* and *Arlington Heights* and reiterated that proof of discriminatory intent in equal protection cases was explicitly mandated in those two decisions.[59]

Perhaps the most significant impact of the *Davis* decision will occur in the school desegregation area. The problem of segregated schools and the attendant problems of busing are ultimately related to the problems of segregated housing.[60] In two recent decisions,[61] the Supreme Court remanded school desegregation cases for consideration in light of *Washington v. Davis* and *Arlington Heights.* The Court's decisions in these school segregation cases indicate that even in this sensitive area the constitutional requirement of intent must be met. The Court's approach makes clear that impact alone will not justify legal remedies aimed at altering the operation of local school systems. The policy considerations involved in the debate over integrated education are similar to those advanced on behalf of integrated housing.[62] That the Court specifically directed the *Davis* standard to be applied in the school cases suggests that the Court also intends the standard to be applied in housing cases.

Moreover, the Supreme Court opinion in *Arlington Heights* itself demonstrates that the Court intended that the *Davis* standards should be applied to *Arlington Heights.* Rather than following the usual procedure of remanding the case to the court of appeals for further consideration,[63] the Court applied *Davis* to the facts of the case and arrived at its conclusion that no constitutional violation had been established. This action indicates that the Court believes

58 97 S.Ct. 1272 (1977).

59 *Id.* at 1288.

60 A concurring opinion by Justice Powell [who wrote the Supreme Court opinion in *Arlington Heights*] in the *Austin* case notes the interrelationship of the problems of housing and school desegregation. Justice Powell said:

> The principal cause of racial and ethnic imbalance in urban public schools across the country—North and South—is the imbalance in residential patterns. Such residential patterns are typically beyond the control of school authorities. For example, discrimination in housing—whether public or private—cannot be attributed to school authorities. Economic pressures and voluntary preferences are the primary determinants of residential patterns.

429 U.S. at 994.

61 United States v. Board of School Commissioners of the City of Indianapolis, 97 S.Ct. 800 (1977); Austin Independent School District v. United States, 429 U.S. 990 (1977).

62 A modern quest for egalitarianism is at the heart of efforts to assure equality in housing and education. Unfortunately, the realities of municipal government, specifically the disparity in tax revenues between units, make it fiscally impossible for a neighborhood comprised of low-income minority families to duplicate the housing conditions and educational opportunities of an upper-middle-class suburb.

63 The irregularity of this procedure was noted in a dissenting opinion by Justice White:

> The Court gives no reason for its failure to follow our usual practice in this situation [*Washington v. Davis* was handed down after the first Seventh Circuit decision in *Arlington Heights*] of vacating the judgment below and remanding in order to permit the lower court to reconsider its ruling in light of our intervening decision. The Court's articulation of a legal standard nowhere mentioned in *Davis* indicates that it feels that the application of *Davis* to these facts calls for substantial analysis. If this is true, we would do better to allow the Court of Appeals to attempt that analysis in the first instance.

429 U.S. at 272.

the *Davis* standard to be determinative of the outcome of the case. The Court could have relied on the record alone to reach its decision on the constitutional issue. It was not necessary to work through a detailed application and analysis of the *Davis* standard to reach the conclusion that there was no evidence of an intent to discriminate in *Arlington Heights*. That the Supreme Court did accord so much weight to the *Davis* standard in this context reinforces the hypothesis that it is the intention of the Supreme Court conclusively to establish the applicability of *Washington v. Davis* to housing cases.

V. Conclusion

The Seventh Circuit, in categorically rejecting the Supreme Court's standards set forth in *Washington v. Davis,* has decided that the constitutional requirement of intent does not apply to the Fair Housing Act. However, the precarious position of the Seventh Circuit with regard to *Davis* suggests that *Arlington Heights* is far from resolution.

The Seventh Circuit's decision in *Arlington Heights* fails to consider the constitutional foundation of national housing policy contained in the Fair Housing Act. Because Title VIII was enacted as part of the Civil Rights Act of 1968, legislation based upon the equal protection clause of the fourteenth amendment, the foundation of the Fair Housing Act is also the equal protection clause. However, to acknowledge this constitutional foundation would have required the court to accept the *Washington v. Davis* standard. Because application of that standard would have produced a result unacceptable to the court, the Seventh Circuit chose not to recognize the constitutional basis of the relief being sought. The court's decision was intended to promote national goals of unquestionable importance. Regardless of this justifiable motive, however, the court is not free to ignore the fact that relief from racial discrimination in housing is predicated on the equal protection clause of the fourteenth amendment. That such discrimination is made specifically illegal by the Fair Housing Act does not change the fundamental nature of discrimination itself. Hearing the *Arlington Heights* case for the first time, the Seventh Circuit relied completely on the fourteenth amendment, holding that the refusal to rezone had a discriminatory effect in violation of the equal protection clause. On remand the court obviously struggled to justify a finding of racial discrimination on some ground other than the equal protection clause. The court resorted to a new standard based on the national housing goals embodied in the Fair Housing Act to arrive at a finding of discrimination. This new standard, however, ignores the fact that discrimination cannot exist independently of the fourteenth amendment. Consequently, the Seventh Circuit cannot deny the applicability of the equal protection clause and at the same time predicate relief on a finding of racial discrimination. As a result, should *Arlington Heights* again reach the Supreme Court, it is likely that the Court will apply the *Davis* standard to the Fair Housing Act, and reverse the Seventh Circuit's decision on remand.

Terry Karnaze

CONSTITUTIONAL LAW—PROCEDURAL DUE PROCESS—DUE PROCESS DOES NOT REQUIRE SEPARATE HEARING ON VOLUNTARINESS OF CONFESSION IN CONTEXT OF BENCH TRIAL.

*United States ex rel. Placek v. Illinois**

In *United States ex rel. Placek v. Illinois*,[1] the Seventh Circuit considered a petition for a writ of habeas corpus which posed the question of whether due process requires a separate hearing on the voluntariness of a confession in the context of a bench trial. In deciding that a separate hearing is not constitutionally mandated, the Seventh Circuit aligned itself with the majority of courts which have passed on this issue. Implicit in the Seventh Circuit's treatment of this issue is an affirmation of the presumed capability of judges to segregate evidence for particular legal analyses. The Seventh Circuit's resolution of the substantive issue adequately reflects the tenor of current federal law, since it restricts federal habeas corpus relief to those cases in which actual prejudice can be shown. It will be demonstrated, however, that the alternative procedural approach of waiver may have been a more appropriate ground on which to decide the case.

Petitioner-appellant Placek was stopped for questioning when police observed him loading large objects into the trunk of a car with mismatched license plates. Placek's inability to explain either his activities or the mismatched plates led to his arrest. A search of the car trunk incident to his arrest revealed two television sets which had been taken from the rooms of an adjacent motel. Although Placek was given *Miranda* warnings, he made certain admissions and signed a note authorizing a search of his apartment shortly after being placed in custody. That search yielded more stolen property which was used, along with the admissions, in evidence at trial.

At his bench trial, Placek objected to testimony given by the arresting police officer concerning the admissions made while in custody. Placek contended that promises of leniency were made to him that vitiated the voluntariness of the statements. Framing his objections in the form of a motion to suppress, Placek requested a hearing on voluntariness. The trial judge remarked that the statements were "clearly voluntary" and refused to grant the motion on the ground that the relevant Illinois statute[2] required that any motion for a hearing be made before trial and on the ground that no evidentiary basis had been laid by the defendant for the motion. After the police officer had testified, categorically denying that any promises of leniency had been made, the judge responded to Placek's renewed requests for a full hearing by reserving the matter pending further evidence. Placek never took the stand at his trial and the record does not reflect further discussion concerning his motion for a suppression hearing.

Placek's argument on his right to a hearing was rejected by both the Illinois

* 546 F.2d 1298 (7th Cir. 1976).

1 546 F.2d 1298.

2 The pertinent section of the statute reads: "The motion [to suppress the confession] shall be made before trial unless the opportunity therefor did not exist or the defendant was not aware of the grounds for the motion. . . ." (ILL. REV. STAT. CH. 38 § 114-11 (g) (1967)).

Appellate Court[3] and the United States District Court for the Northern District of Illinois.[4] Both courts reasoned that the motion at trial was precluded by the relevant Illinois statute.[5] The state procedure, according to these courts, insured that due process requirements had been met since the statute provided Placek with sufficient opportunity to exercise his constitutional right to a hearing on voluntariness before trial. Placek was aware prior to trial that the evidence would be used and, therefore, he was deemed to have waived his constitutional right to a hearing by failing to comply with the state procedural statute.

Although several issues were presented on appeal,[6] Placek's claim that he was denied his constitutional right to a hearing on the voluntariness of his confession was the focus of the Seventh Circuit's attention. The issue of waiver, the basis of the decisions in the lower courts, never appears in the Seventh Circuit's opinion. Rather, the court proceeded directly to the federal due process question and held that a separate hearing serves no real purpose in a bench trial and is therefore not constitutionally required. The Seventh Circuit concluded that Placek forfeited his voluntariness claim when he elected not to present evidence on it at trial. In the court's view, Placek had not waived his right to a hearing, but had merely postponed it to the trial itself.

The thrust of the opinion is that the voluntariness determination can be made by the judge during the very course of the trial. Moreover, the court found sufficient testimony in the record to warrant a finding that the trial judge had given the question due consideration. Pointing to the testimony of the arresting police officer which Placek failed to refute, the Seventh Circuit concluded that the voluntariness determination at the trial level was adequate: "[t]he record clearly supports the trial court's preliminary finding of voluntariness and does not reveal any reason to reconsider that finding. Accordingly, we conclude that the court's voluntariness determination appears from the record with unmistakable clarity. . . ."[7] Thus, the Seventh Circuit concluded that a separate evidentiary hearing in the district court was not warranted, since the defendant had merely failed properly to establish his claim in the court below.

The basis of Placek's appeal was that, had he been granted a separate hearing, he would have been better able to refute the voluntariness of his statements. The denial of his motion, according to Placek, indicated that he had not been afforded due process in the voluntariness determination. In making his claim for a separate hearing, Placek argued that the protections extended in a jury trial setting in *Jackson v. Denno*[8] should be found applicable to a bench trial. In *Jackson v. Denno,* the United States Supreme Court questioned the ability of a jury to separate the truthfulness of a confession from a consideration of voluntariness. The Court expressed concern that the jury might not appreciate the

3 People v. Placek, 25 Ill. App.3d 945, 323 N.E.2d 410 (1975).
4 United States ex. rel Placek v. Illinois, No. 75 C 3614 at 5 (N.D. Ill. Feb. 24, 1976) (Judgment Order).
5 *See* note 2 *supra.*
6 A search and seizure argument was precluded by *Stone v. Powell.* Under *Stone,* when the state has provided an opportunity for full and fair litigation of a fourth amendment claim of unconstitutional search and seizure, federal grants of habeas corpus must be denied. 428 U.S. 465 (1976).
7 546 F.2d 1307.
8 378 U.S. 368 (1964).

policy reasons behind keeping these factors separate and would base its decision on voluntariness on the confession's truthfulness. To obviate this problem, the Court ruled that the trial judge should determine the issue of voluntariness in a suppression hearing held apart from the jury. This procedure, in the opinion of the Court, had the further beneficial effect of totally insulating the trier of fact on the issue of guilt or innocence from suspect confessions, and, therefore, no reliance could be placed upon an involuntary, albeit truthful, confession. The question presented by Placek was whether a judge, sitting as trier of fact, must be similarly insulated from involuntary confessions.

In addressing this issue, the Seventh Circuit had available to it an expanding body of state law. At the federal level, however, the issue had only been reached by two federal district courts in Pennsylvania.[9] In deciding *Placek,* the court rejected these federal decisions and relied, instead, on the state analysis.

In *United States ex rel. Owens v. Cavel,*[10] the United States District Court for the Middle District of Pennsylvania granted a writ of habeas corpus when the judge made the voluntariness determination during the course of a bench trial. The district court expressed the fear that extraneous circumstances could distort the issue of voluntariness resulting in a denial of due process of law. The court reasoned that when there was no separate hearing, the issue of voluntariness could be intermixed through the entire trial. As a result, it could not be certain that the determination of voluntariness had been made independently from considerations pertaining to the defendant's guilt.

This reasoning was carried a step further in *United States ex rel. Spears v. Rundle,*[11] in which the District Court for the Eastern District of Pennsylvania held that upon learning that the voluntariness of a confession was questioned, the trial judge must order a separate hearing before another judge unfamiliar with the case and testimony. Relying on the reasoning of *Jackson v. Denno,*[12] the court felt that it was too great a burden to require a judge who has heard evidence of guilt "to objectively and coldly assess a distinct issue as to the voluntariness of a confession."[13]

Further support for the separate hearing requirement in a bench trial appears in *McCormick On Evidence,*[14] in which it is argued that the determination of voluntariness should be made apart from the trial on guilt or innocence, and that the record should contain a specific finding of voluntariness made before the beginning of evidence on the issue of guilt.

While most state courts find the procedure outlined in *McCormick* to be preferable, they will not reverse without a showing of actual prejudice on the part of the judge. This position is clearly expressed in an opinion of the appellate court of Illinois:

> [t]here can be no *assumption* that the trial judge cannot make a *reliable* determination of the voluntariness of the confession under the circumstances

9 254 F.Supp. 154 (M.D. Pa. 1966), 268 F.Supp. 691 (E.D. Pa. 1967), *aff'd on other grounds,* 405 F.2d 1037 (3d Cir. 1969).
10 254 F.Supp. 154.
11 268 F.Supp. 691.
12 378 U.S. 368.
13 268 F.Supp. at 695.
14 McCormick On Evidence 351 (2d ed. 1972).

> which developed in this bench trial, and there can be no assumption of his inevitable prejudice in making that determination; rather, there must be some indication in the record which demonstrates actual prejudice.

Thus, the defendant must develop a record from which he can clearly demonstrate error. There can be no reliance on defendant-oriented presumptions in this area. If the defendant has failed to build a record from which he can show prejudice, state courts will presume, instead, that the judge was not biased.

The courts holding this view draw a clear distinction between judges and juries as triers of fact. In the language of the Supreme Court of Maryland: "[t]he assumed proposition that judges are men of discernment, learned and experienced in the law and capable of evaluating the materiality of evidence, lies at the very core of our judicial system."[16] In the absence of prejudice appearing in the record, the presumption is that a trial judge, sitting as trier of fact, is not prejudiced by irrelevant or otherwise inadmissible information that has come to his attention.[17]

The holding in *Placek* to the effect that judges can consider questions of voluntariness in conjunction with trial, therefore, places the Seventh Circuit in line with the state courts which have reviewed the question. The Seventh Circuit's position, however, is somewhat qualified since the court held only that a separate hearing was not necessary in the context of Illinois law.[18] Under that system, the defendant would have been subject to cross-examination limited to the scope of his direct testimony both at trial and at a hearing. In both instances, he would have been subject to impeachment which would be heard by the same trier of fact. Indeed, since Placek never requested a different trier of fact, his entire argument centered on the narrow issue of whether the hearing could be mixed into the course of the trial itself. The Seventh Circuit decided that the procedure employed did not require reversal in the absence of a showing of prejudice.[19]

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15 People v. Fultz, 32 Ill. App. 3d 317, 336 N.E.2d 288, 302 (1975).

16 State v. Hutchinson, 260 Md. 277, 271 A.2d 641, 646 (1970).

17 People v. Brown, 24 N.Y.2d 168, 299 N.Y.S.2d 190, 247 N.E.2d 153, 155 (1969); Akers v. Commonwealth, 216 Va. 50, 216 S.E.2d 28, 31 (1975).

See also Case Comment, 38 FORD. L. REV. 120 (1969), for an analysis of People v. Brown, 24 N.Y.2d 168, 299 N.Y.S.2d 190, 247 N.E.2d 154, 155 (1969). That case also held that the doctrine of *Jackson v. Denno* is inapplicable in a nonjury trial. The Case Comment also includes an extensive list of source material on the functions of judge and jury. Of special note are Morgan, *Functions of Judge and Jury in the Determination of Preliminary Questions of Fact,* 43 HARV. L. REV. 165 (1929) and Meltzer, *Involuntary Confessions: The Allocation of Responsibility Between Judge and Jury,* 21 CHI. L. REV. 317 (1954).

18 546 F.2d at 1305, People v. Kirkwood, 17 Ill.2d 23, 160 N.E.2d 766, 771 (1959), *cert. denied,* 363 U.S. 847 (1960).

19 *See* note 15 *supra; see also* United States ex rel. Placek v. Illinois, the principal case. In *Placek,* the court states:

> By holding that due process was not offended by the state procedure employed in this case, we do not wish to commend to other courts the practice of holding a voluntariness hearing in conjunction with a bench trial. We have previously looked with disfavor on procedures that permit incriminating evidence to work a "potential influence" on a trial judge's consideration of the voluntariness issue. United States ex rel. Hickman v. Sielaff, 521 F.2d 378, 386 (7th Cir. 1975). Holding a pretrial hearing, or a separate hearing when the voluntariness issue is first raised at trial, seems preferable in order to minimize the possibility that such improper influence might arise. However, the Constitution, of course, gives us no supervisory power to compel state courts to follow our "preferences" regarding trial procedures.

546 F.2d at 1306 n.8.

The practical effect of the holding is to place a premium on effective defense counsel. To insure that a defendant receive the fairest determination of his voluntariness claim, the burden is on counsel to request a hearing prior to trial. Indeed, the applicable statute may require it. Assuming the questionable testimony is first discovered during trial, prompt determination of the claim, before further evidence of guilt is presented, can be critical. In all cases, a full record should be developed and should include the judge's findings. In this way, any possible signs of prejudice can be presented for review on appeal. There is a burden on the judge to maintain impartiality, but the ultimate burden is on the lawyer to object should he perceive bias on the part of the judge.

Turning to the record as developed in *Placek,* it should be noted that, from the outset, Placek's case presented an unfavorable context in which to argue for an extension of further constitutional protections. Throughout the case, there are critical decisions, presumably made with the assistance of counsel, which worked to create a weak record. By failing to testify, Placek provided the reviewing courts with no means by which to evaluate his voluntariness claim. The trial judge demonstrated a willingness to reconsider his decision on Placek's motion should further evidence require it. Placek, however, rested his case without fully pressing his claim at trial.

In other words, when Placek chose not to present evidence at trial, the Seventh Circuit had no basis on which to evaluate the adequacy of that forum. The judge was never presented with the relevant evidence in support of Placek's claim. The Seventh Circuit, therefore, had no means of determining whether the trial judge's evaluation had been biased by his having heard the evidence during trial rather than at a separate hearing. Rather, the Seventh Circuit, presented with the police officer's unrefuted testimony regarding Placek's statements, could only conclude that the judge had made a fair finding on the matter of voluntariness.

The Seventh Circuit thus was able to base its decision in *Placek* on the presumed capability of judges to segregate evidence for particular purposes because of the failure of Placek's counsel to develop evidence on voluntariness at trial. However, the United States Supreme Court decision in *Wainwright v. Sykes,*[20] although decided after *Placek,* indicates that an alternative analysis of waiver was available to the Seventh Circuit in *Placek.* In *Wainwright,* the Supreme Court indicated a preference for waiver analysis in the presence of procedural default. As such, *Wainwright* marks an important step in a line of waiver decisions.

Development of Waiver Analysis

Fay v. Noia[21] marked the beginning of the Supreme Court's recent treatment of waiver and held that federal habeas corpus should not be limited by state procedural defaults unless the applicant had "deliberately bypassed" the orderly procedure of the state courts. *Fay* also reiterated the language found in *Johnson v. Zerbst*[22] that the waiver must be knowing and an actual and in-

20 97 S.Ct. 2497 (1977).
21 372 U.S. 391 (1963).
22 304 U.S. 458, 464 (1938).

tentional relinquishment or abandonment of a known right or privilege. The last major case which typified the Court's liberal waiver analysis was *Henry v. Mississippi*.[23] Although that case was decided on direct review, it did enunciate another test that the Court has used: whether the state procedural rule serves a legitimate state interest.

The Supreme Court began to retreat from these prior holdings, however, in *Davis v. United States*[24] and, later, in *Francis v. Henderson*.[25] In these cases, the Court noted that it had the jurisdictional power to entertain the claims advanced, but declined to exercise its power for reasons of comity and concerns for the orderly administration of criminal justice.[26] In both cases, the Court held that objections to grand jury compositions were deemed to have been waived in the absence of a showing of cause for noncompliance with state procedure and without some showing of actual prejudice resulting from the alleged constitutional violation.

Wainwright extended this rationale to the context of a suppression hearing on voluntariness of defendant's statements. The defendant's petition was denied because he had not complied with state procedure, had not explained his reason for noncompliance, and had not been prejudiced by the loss of his constitutional right since there was ample evidence aside from his confession on which to base the conviction.[27]

Waiver Analysis Extended to Voluntariness Hearings

In *Wainwright,* the respondent defendant, Sykes, failed to advance his challenge to the effectiveness of *Miranda* warnings, given to him while he was intoxicated, until after his murder conviction had been appealed through the state appellate process. Although he later challenged the admissibility of the statements in a motion to vacate the conviction and in state habeas corpus petitions, he met with no success until reaching the United States District Court for the Middle District of Florida on a petition for federal habeas corpus.[28] The district court ruled that under *Jackson v. Denno,* Sykes had a right to a hearing in the state court on the voluntariness of his statements and that he had not lost that right by failing to assert his claim at trial or on appeal. The Court of Appeals for the Fifth Circuit affirmed,[29] holding that Sykes' failure to comply with Florida's contemporaneous objection rule[30] did not bar review of the sup-

23 379 U.S. 443 (1965).
24 411 U.S. 233 (1973).
25 425 U.S. 536 (1976).
26 *Id.* at 538-39.
27 97 S. Ct. at 2508-09.
28 *Id.* at 2500.
29 528 F.2d 522 (5th Cir. 1976).
30 The Florida statute is almost identical to the Illinois statute with which Placek failed to comply. The pertinent sections of the Florida statute state:

> Motion to Suppress a Confession or Admissions Illegally Obtained.
> (1) Grounds. Upon Motion of the defendant or upon its own motion, the court shall suppress any confession or admission obtained illegally from the defendant.
> (2) Time for Filing. The motion to suppress shall be made prior to trial unless opportunity therefor did not exist or the defendant was not aware of the grounds for the motion, but the court in its discretion may entertain the motion or an appropriate objection at trial.

FLA. RULES CRIM. PROC. 3.190(i).

pression claim unless the right to object was deliberately bypassed for tactical reasons.

In reversing the judgment of the Fifth Circuit, the Supreme Court seized the opportunity to set down a relatively strict test for waiver of a voluntariness hearing. The Court struck down its own rationale of deliberate bypass first announced in *Fay v. Noia*[31] and substituted a two-pronged test involving a showing of actual cause for the procedural default and prejudice from the loss of the waived right.

The area of controversy, in the opinion of the Court, concerns the reviewability of federal claims which the state court has declined to pass on because not presented in the manner prescribed by its procedural rules. The *Wainwright* Court termed the procedural default an adequate and independent state ground barring consideration of otherwise cognizable federal issues on federal habeas corpus review.[32] In reaching this decision, the Supreme Court based its reliance on procedural default in part on the merits of the "contemporaneous objection" rule. The Court stressed the efficacy of the rule in promoting finality at trial:

> To the greatest extent possible all issues which bear on this charge should be determined in this proceeding: the accused is in the court room, the jury is in the box, the judge is on the bench, and the witnesses, having been subpoenaed and duly sworn, await their turns to testify. Society's resources have been concentrated at that time and place in order to decide, within the limits of human fallibility the question of guilt or innocence of one of its citizens. Any procedural rule which encourages the result that those proceedings be as free of error as possible is thoroughly desirable, and the contemporaneous objection rule surely falls within this classification.[33]

In the opinion of the Court, adherence to the "contemporaneous objection" rule adds to the perception "of the trial of a criminal case in a state court as a decisive and portentous event."[34]

In light of this discussion, it is apparent that *Placek* is, in most respects, indistinguishable from *Wainwright*. A procedural default was present since no pretrial hearing was requested. At trial, however, Placek's attorney did make a contemporaneous objection to the testimony of the arresting officer regarding admissions made by Placek. Regardless of this objection, the resolution of the case would be the same. The proper time for Placek's hearing request was prior to trial. When made during trial instead, Placek was unable to make the higher showing of cause necessary at that stage in the proceedings. In effect, then, Placek lost the right to a separate hearing on voluntariness due to the original procedural default of failing to request a hearing prior to trial.

Because of the procedural default, *Placek* could have been decided as was *Wainwright* without reaching the federal question. *Placek* involved a substantive

31 372 U.S. 391.

32 *See generally* Hill, *The Inadequate State Ground*, 65 COLUM. L. REV. 943 (1965) and Sandalow, *Henry v. Mississippi and the Adequate State Ground; Proposals for a Revised Doctrine*, 1965 SUP. CT. REV. 187 (1965) for a history of the adequate state ground doctrine and a discussion of some proposed factors for determining adequacy.

33 97 S.Ct. at 2508.

34 *Id.*

federal question—adequacy of the hearing provided—and a procedural default: failure to make a timely request for a hearing. If the case were decided today, the Seventh Circuit would probably elect a waiver rationale based on the procedural default and analogous to *Wainwright*.

Placek would have fared no better under this analysis, however, since it is clear that he would not meet the tests of cause and prejudice set forth in the Supreme Court's waiver decisions. The apparent reason, although no reason was ever presented to the Court, for the procedural default in *Wainwright* was attorney neglect. This was found insufficient to warrant relief. Similarly, the record shows that Placek's attorney was unaware of an amendment requiring requests for hearings to be made prior to trial. Whether attorney neglect, when presented to a court as cause for the noncompliance, will be sufficient has not yet been decided. It is clear, however, that future defendants will also have to meet the second part of the test: a showing of prejudice from the alleged constitutional violation.

In a dissent to the *Wainwright* decision, Justice Brennan, joined by Justice Marshall, urged that federal habeas corpus relief should be available to correct the inadvertence and neglect of counsel. *Fay v. Noia*,[35] requiring deliberate bypass or knowing waiver, provided this safeguard. According to Justice Brennan, in the absence of content for what the Court calls "cause and prejudice," a defendant's constitutional rights may be abridged without any attorney decision whatsoever:

> I believe that the demands of our criminal justice system warrant visiting the mistakes of a trial attorney on the head of a habeas corpus applicant only when we are convinced that the lawyer actually exercised his expertise and judgment in his client's service, and with his client's knowing and intelligent participation where possible.[36]

While this criticism may be valid, it is not yet clear that the Court has chosen not to provide such relief. Rather, the holding of the majority in *Wainwright* is that attorney error will not be inferred. Cause for the default must be shown.

Although the holdings in *Placek* and *Wainwright* each exert pressure on judge and counsel to see that due process is afforded at the trial level, a progression is present. In *Placek*, the Seventh Circuit expressed an optimism that judges can completely exclude inadmissible evidence from consideration. A further optimism is demonstrated in the ability of counsel to make appropriate and timely choices in defense of clients. *Wainwright* transformed this optimism in the ability of judge and lawyer into requirements. In its decision, the Supreme Court held that absent a showing of good cause for a procedural default and a showing of actual prejudice resulting therefrom, rights not exercised at trial are waived. Under this analysis, therefore, a strong presumption exists that judges and lawyers have properly performed their duties.

Both *Placek* and *Wainwright* restrict the availability of federal courts to habeas corpus petitioners. In *Placek*, the Seventh Circuit denied an evidentiary

35 372 U.S. 391.
36 97 S. Ct. at 2522.

hearing in the district court on the ground that petitioner had been afforded an adequate hearing at his state trial. In *Wainwright,* the Supreme Court evidenced an intention to deny federal review to constitutional claims if not raised at the state level due to procedural default.

These holdings represent attempts by each court to reach workable models for federal review within the criminal justice system. Neither court is willing to presume lack of ability, whether on the part of judges discriminating between tainted and admissible evidence or on the part of attorneys trying criminal cases. If errors are made, however, both resolutions provide remedies upon a showing of actual injury. The availability of remedies is implicit in both the Supreme Court's test for waiver—absence of a showing of cause for default and prejudice from the constitutional forfeiture—and in the Seventh Circuit's opinion: "Placek has made no showing that his rights were prejudiced by the trial judge's contemporaneous consideration of evidence of guilt along with evidence bearing on the voluntariness of his confession . . ."[37]

The Supreme Court's waiver test will have the salutary effect of pressuring counsel to focus attention on the state trial. Habeas corpus can be a slow and arduous process for correcting needless mistakes at trial. A remedy for the denial of constitutional rights is available, however, if the waiver test is met. If future cases provide sufficient content for the terms "cause" and "prejudice," an efficient and fundamentally fair standard for affording federal review on habeas corpus will have been established.

In *United States ex rel. Placek v. Illinois,* the appellant failed to show prejudice from the fact that his voluntariness hearing was held during the course of his bench trial. As a result the Seventh Circuit was powerless to evaluate the merit of Placek's claim, and relief was accordingly denied. Given Placek's failure to show actual prejudice, it is clear that his appeal would have met with the same result had the Seventh Circuit approached the case from the perspective of a waiver analysis. This judicial insistence on an affirmative showing of harm from alleged constitutional violations reflects a sound jurisprudence: it precludes frivolous claims, yet affords judicial intervention when individual rights are actually prejudiced by government action.

Genevieve M. Keating

37 546 F.2d at 1305.

EQUAL PROTECTION—DOUBLE JEOPARDY—FOURTEENTH AMENDMENT REQUIRES SENTENCE CREDIT FOR ALL PERIODS OF PRESENTENCE CONFINEMENT; A JUDICIAL PRESUMPTION OF CREDIT IS IMPROPER IN THE CONSTITUTIONAL CONTEXT OF A HABEAS CORPUS PROCEEDING.

*Johnson v. Prast**

I. Introduction

In state criminal prosecutions, a defendant unable to post bail often remains incarcerated from arrest to conviction. An assertion of the sentencing court's failure to grant credit for such confinement often serves as the basis of a state prisoner's habeas corpus petition. In response to these petitions, a growing number of federal courts have interpreted the fourteenth amendment's equal protection clause to require credit for presentence incarceration occasioned solely by the defendant's indigency.[1] Less certain, however, has been the existence of a constitutional right to credit when presentence confinement does not extend the total period of incarceration beyond the statutory maximum.[2] Moreover, as a procedural caveat to the granting of presentence credit, many federal courts have applied a presumption that credit was given by the sentencing judge in cases where the term imposed together with the presentence incarceration does not exceed the statutory maximum.[3]

In *Johnson v. Prast*,[4] the United States Court of Appeals for the Seventh Circuit was confronted with defining the scope of the defendant's constitutional right to credit for presentence incarceration occasioned by indigency. Additionally, the court was required to determine the applicability of a judicial presumption of credit when a constitutionally guaranteed right was at issue.

The Seventh Circuit affirmed an indigent's constitutional right to credit irrespective of whether the presentence incarceration extends the total period of confinement beyond the statutory maximum.[5] Further, the *Johnson* court held that a judicial presumption of credit is inappropriate in the constitutional context of a habeas corpus proceeding.

Significantly, however, the court's opinion was flawed by its inconsistent treatment of the constitutional bases for credit. The court based the appellants' right to credit on the equal protection guarantee and rejected without discussion the alternative argument asserted of a violation of the fifth amendment prohibition of double jeopardy.[6] Yet in summarily dismissing the double jeopardy argument, the *Johnson* court relied on precedent that supports the constitu-

* 548 F.2d 699 (7th Cir. 1977).

1 *See, e.g.*, King v. Wyrick, 516 F.2d 321 (8th Cir. 1975); Ham v. North Carolina, 471 F.2d 406 (4th Cir. 1973); White v. Gilligan, 351 F. Supp. 1012 (S.D. Ohio 1972); *But see* Gremillion v. Henderson, 425 F.2d 1293 (5th Cir. 1970).

2 *See, e.g.*, Parker v. Estelle, 498 F.2d 625 (5th Cir. 1974), *cert. denied*, 421 U.S. 963 (1975); Hook v. State of Arizona, 496 F.2d 1172 (9th Cir. 1974); Hill v. Wainright, 465 F.2d 414 (5th Cir. 1972); Hart v. Henderson, 449 F.2d 183 (5th Cir. 1971).

3 *See* note 55 *infra*.

4 548 F.2d 699 (7th Cir. 1977).

5 548 F.2d at 702.

6 *Id.* at 701 n.3.

tionality of a presumption of credit for presentence confinement.[7] The Seventh Circuit's approach to the two constitutional issues is therefore in conflict: the court rejects any presumption of credit as violative of equal protection, but implicitly supports the presumption as applied to double jeopardy claims.

II. Statement of the Case

The *Johnson* court decided together the appeals of Elmer Johnson and Harold Smith, who collectively and for separate crimes had spent 173 days confined to jail before trial and conviction for the offenses charged. Johnson was serving concurrent three-year sentences in the Wisconsin Correction Camp System when he escaped in December, 1974. He was arrested on another charge in Salem, Oregon, on March 7, 1975. Financially unable to post bail, Johnson remained in the custody of Oregon officials until extradited to Wisconsin on March 27, 1975. Again unable to post bail,[8] Johnson was returned to the Dane County Jail in Wisconsin to await trial on the escape charge. On April 14, he was convicted of that charge and sentenced to the statutory minimum of one year. The transcript of the April 14 hearing contained no mention of the 39-day period that Johnson spent in custody between his arrest in Oregon and his sentencing on the escape charge in Wisconsin.

On a motion for post-conviction review, Johnson alleged that his sentence had been imposed without consideration of presentence custody. In an order denying the motion, the sentencing judge concluded that reducing the sentence in light of that custody would have been "inappropriate."

Before the United States District Court for the Eastern District of Wisconsin on habeas corpus, Johnson asserted that his right to equal protection had been violated by the alleged failure of the sentencing judge to credit the presentence jail time. The district court adopted the view that consideration of presentence jail time is a matter not of constitutional right, but of the sentencing court's discretion. The district court held that Johnson had not met his burden of showing that there had been an abuse of discretion by the sentencing judge. Accordingly, the court concluded that no constitutional question actionable on habeas corpus had been raised.[9]

Smith, the appellant in the companion case decided by the Seventh Circuit, had received indeterminate sentences totaling twelve years upon conviction under a Wisconsin indictment charging offenses for which the total maximum imprison-

7 *See* text accompanying note 100 *infra.*

8 The Seventh Circuit questioned in a footnote the state's apparent concession that a captured escapee is eligible for bail. The court concluded that although it may seem odd that a captured escapee would ever be entitled to bond, it appeared that, at least while he was being held in Oregon on a fugitive warrant, Johnson was entitled to a determination fixing bail bond. Further, the Seventh Circuit stated that since the existence of a case or controversy depended on whether Johnson was eligible for bail at any time during the 39 days, it would go beyond the state's concession and leave to the district court the decision whether to allow the state to withdraw in any degree from that concession. 548 F.2d 700, 701, n.1.

9 The district court's citation of Monsour v. Gray, 375 F. Supp. 786 (E.D. Wis. 1973), indicates the court's supposition that a presumption of credit is utilized when the sentence imposed is less than the statutory maximum. In *Monsour,* a clear acknowledgement by the sentencing judge of his failure to grant credit was necessary to negate the presumption. See 548 F.2d at 701 n.4.

ment was twenty-seven years and six months. When sentenced, Smith had already been in custody 134 days because of financial inability to make bail. The sentencing record did not indicate whether the judge gave consideration to the presentence custody in fixing the sentence.

The eastern Wisconsin district court dismissed Smith's habeas corpus petition, noting that the total of presentence custody and sentences imposed did not exceed the statutory maximum. In that instance, the court held, it would presume that credit had been given.

On separate appeals to the Seventh Circuit, Johnson and Smith again alleged that the failure to grant credit for their presentence confinement violated the fourteenth amendment's equal protection clause. Johnson argued alternatively that the denial of credit violated the fifth amendment's prohibition against double jeopardy.[10]

III. The Evolution of a Constitutionally Created Right to Credit for the Indigent Defendant

Federal prisoners are statutorily granted the right to credit for presentence confinement.[11] Appellants Johnson and Smith, however, had been convicted of state offenses and were before the federal court on the basis of habeas corpus. Thus, although the principal issue before the *Johnson* court was the viability of a judicial presumption of credit, the threshold question was whether the appellants were constitutionally entitled to credit for the time spent in presentence detention.

In the absence of a Supreme Court decision specifically addressing the issue of credit for presentence incarceration,[12] the federal courts have applied an analogous line of reasoning developed by the Supreme Court with respect to the indigent defendant and the criminal process.[13] The focal point of that development is the Supreme Court's decision in *Williams v. Illinois*,[14] in which the narrow issue raised was whether an indigent prisoner could be held in confinement beyond the statutorily specified maximum term because of his failure to satisfy the fine accompanying his sentence. The Supreme Court asserted that this practice would make the duration of an individual's confinement contingent upon his ability to pay and therefore held that a state could not imprison beyond the statutory maximum a defendant financially unable to pay a fine.[15] The Court stated that "[t]he equal protection clause of the fourteenth amendment requires that the statutory ceiling placed on imprisonment for any sub-

10 The double jeopardy argument was theorized on multiple punishment for the same offense. See note 95 *infra*.

11 Act of September 2, 1960. Pub. L. No. 86-691, § 1(a), 74 Stat. 738, *as amended*, 18 U.S.C. § 3568 (1970).

12 *But see* United States v. Gaines, 402 U.S. 1006 (1971).

13 The following are principal cases in that line of development: Griffin v. Illinois, 351 U.S. 12 (1956) (state must provide indigent appellant with free trial record); Gideon v. Wainright, 372 U.S. 335 (1963) (indigent's right to counsel in state criminal proceeding); Douglas v. California, 372 U.S. 353 (1963) (indigent's right to counsel for purposes of direct appeal).

14 399 U.S. 235 (1970).

15 *Id.* at 241.

stantive offense be the same for all defendants irrespective of their economic status."[16]

Soon to follow was *Morris v. Schoonfield*,[17] in which the Supreme Court addressed the Maryland practice of incarcerating indigent defendants for nonpayment of fines for offenses that would otherwise not carry a jail term. In a memorandum decision, the Court remanded the case to the district court for reconsideration in light of the Court's holding in *Williams*. In a concurring opinion, Justice White commented on the applicability of the *Williams* rationale:

> The same constitutional defect condemned in *Williams* also inheres in jailing an indigent for failing to make immediate payment of any fine, whether the fine is accompanied by a jail term and whether or not the jail term of the indigent extends beyond the maximum term that may be imposed upon a person willing and able to pay a fine. In each case the Constitution prohibits the state from imposing a fine as a sentence and then automatically converting it into a jail term solely because the defendant is indigent and cannot forthwith pay the fine in full.[18]

Justice White thus sought to make clear that the Court's holding in *Williams* was not limited to the extension of an existing jail term, but included as well, any enhancement of a defendant's punishment resulting solely from his inability to pay.

The position set forth in Justice White's concurrence was subsequently adopted by the Supreme Court in *Tate v. Short*.[19] In *Tate* the Court held violative of equal protection the traditional "30 days or 30 dollars" sentencing scheme whereby the defendant must choose between paying a fine or "doing time,"[20] an illusory choice for the indigent.

The Supreme Court's primary concern in these cases was the arbitrary imposition or extension of punishment due solely to indigency. With deference to the Supreme Court's concern, many lower federal courts could find no valid distinction between indigents subjected to a jail sentence solely because of their inability to pay a fine, and indigents subjected to presentence incarceration solely because of their inability to post bail. Hence, with the *Williams-Morris-Tate* trilogy as backdrop, the lower federal courts began to address the sentence credit issue cognizant of the constitutional implications.

A. *Determining the Scope of the* Williams *Doctrine*

In *Johnson*, neither appellants' total period of confinement—*i.e.*, the period spent in presentence confinement and the term judicially imposed—exceeded the statutory maximum. Nonetheless, the *Johnson* court expressly adopted the holding implicit in its recent decision in *Faye v. Gray*[21] and extended the indigent's constitutional right of credit to all periods of presentence confinement

16 *Id.* at 244.
17 399 U.S. 508 (1970) (mem.).
18 *Id.* at 509 (White, J., concurring).
19 401 U.S. 395 (1971).
20 *Id.* at 398.
21 541 F.2d 665 (7th Cir. 1976).

irrespective of the statutory maximum.[22] In *Faye,* the Seventh Circuit asserted that the indigent's right to consideration of presentence detention is constitutionally based even if the total detention is below the statutory maximum.[23] In further support of that principle, the *Johnson* court relied on a developing line of decisions in which the federal courts have required credit for *all* periods of presentence confinement.[24]

Among those decisions is the Eighth Circuit's holding in *King v. Wyrick.*[25] In *King* the Eighth Circuit asserted:

> It is obvious . . . that equal protection considerations obtain as well in the case of an indigent prisoner who is denied jail time credit on a prison term less than the allowable maximum prescribed by statute. He must still serve a longer term in connection with the offense than would a wealthier prisoner who is able to meet bail to avoid incarceration before trial and sentencing.[26]

Thus, rather than focusing on whether the total period of confinement exceeded the statutory maximum, the Eighth Circuit's holding in *King* was based solely upon the disparity between the length of confinement of indigent and non-indigent defendants.

Similarly, in *Workman v. Cardwell*[27] the Court of Appeals for the Sixth Circuit granted credit for presentence confinement to an indigent defendant who had been given less than the statutory maximum term. The court stated that the granting of such credit was a logical extension of the equal protection rationale advanced in *Williams.*[28] Neither the *Workman* court nor the Eighth Circuit in *King* could find any justification in the *Williams* and *Tate* decisions for distinguishing between periods of presentence incarceration on the basis of whether such confinement extended the total period of incarceration beyond the statutory maximum.

The Fifth and Ninth Circuits, however, have consistently held to the contrary.[29] Both courts have held that the indigent's constitutional right to credit does not arise unless the aggregate term of incarceration exceeds the statutory maximum.[30] Based upon a narrow interpretation of the *Williams* line of cases, these courts have implicitly reasoned that where presentence confinement does not extend the total period of custody beyond the statutory maximum, the accused has no real grievance since the trial court *could* have imposed the maximum sentence.[31]

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22 548 F.2d at 702.
23 541 F.2d at 668.
24 *See, e.g.,* Workman v. Cardwell, 471 F.2d 909 (6th Cir. 1972), *cert. denied,* 412 U.S. 932 (1973). 516 F.2d 321; 471 F.2d 406.
25 516 F.2d 321.
26 *Id.* at 323.
27 471 F.2d 909.
28 *Id.* at 910.
29 *See, e.g.,* Jackson v. Alabama, 530 F.2d 1231 (5th Cir. 1976); Corley v. Cardwell, 544 F.2d 349 (9th Cir. 1976), 97 S. Ct. 757 (1977). 496 F.2d 1172; 449 F.2d 183.
30 530 F.2d at 1237; 496 F.2d at 1174; 449 F.2d at 185; 544 F.2d at 353.
31 However, as one commentator has noted with respect to such an argument:
> The significant point . . . is that the court did not do so; and to take the court's shorter sentence and extend it because of indigency is to discriminate on the basis of wealth . . . . Thus, it is just as discriminatory to effect an extension of imprisonment

In *Jackson v. Alabama,*[32] the Fifth Circuit emphasized the language of the *Williams* decision which held unconstitutional the imprisonment of an indigent beyond the *statutory maximum* solely because of his inability to pay a fine.[33] Relying on this language, the *Jackson* court held that presentence confinement must extend the total period of custody beyond the statutory maximum in order to activate the indigent defendant's constitutional right to credit.[34] The court interpreted *Williams* to define the statutory maximum as the outer limit of incarceration necessary to satisfy the state's penological interest. The *Jackson* court viewed any incarceration within that limit as constitutionally permissible.[35]

The Seventh Circuit's interpretation of the *Williams* trilogy in *Johnson* is more tenable. This is particularly true in light of the Supreme Court's decision in *Tate,*[36] in which the Court expressly rejected the contention that applicability of the *Williams* doctrine depends upon whether the total period of incarceration exceeds the statutory maximum.[37] In adopting Justice White's concurring opinion from *Morris,* the *Tate* Court held that the same constitutional defect condemned in *Williams* would also inhere in jailing an indigent "whether or not the jail term extends beyond the statutory maximum term. . . ."[38] Although *Johnson* concerned an indigent's inability to pay bail rather than a fine as in *Tate,* the *Tate* Court's admonition is clearly pertinent.

Further, the Supreme Court's reference in *Williams* to the statutory maximum as defining the outer limits of incarceration necessary to satisfy the state's penological interest[39] should not be interpreted so rigidly as to infer that only incarceration beyond that point will violate the indigent's right to equal protection.[40] As Justice Harlan stated in his concurring opinion in *Williams,* a judicial determination of effective punishment reflected by a sentence less than the statutory maximum also defines the outer limits of the state's penal interest insofar as that particular case is concerned.[41] A denial of credit for incarcera-

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beyond the court imposed limit as it is to do so beyond the statutory limit. Note, *Sentence Crediting for the State Criminal Defendant—A Constitutional Requirement,* 34 OHIO ST. L.J. 586, 588 (1973).

32 530 F.2d 1231.

33 399 U.S. at 241.

34 530 F.2d at 1235-1237.

35 The Ninth Circuit apparently adopts the rationale of the Fifth Circuit in *Jackson.* Without discussion, the Ninth Circuit has consistently cited the Fifth Circuit as support for its conclusion that only custody in excess of the statutory maximum is constitutionally violative. *See* 496 F.2d at 1174.

36 401 U.S. 395.

37 *Id.* at 398.

38 *Id.*

39 *See* 399 U.S. at 241, 242.

40 *See* Schornhorst, *Presentence Confinement and the Constitution: The Burial of Dead Time,* 23 HAST. L.J. 1041, 1059 (1972).

41 399 U.S. 235 at 265 (Harlan, J., concurring). With respect to the state's interest, the *Johnson* court stated that it had considered the Supreme Court's decision in McGinnis v. Royster, 410 U.S. 263 (1973). In *McGinnis,* the Court used traditional equal protection analysis to find a "legitimate state interest" in a New York statute that denied "good time" credit (i.e., credit for good conduct) to prisoners serving their presentence detention in a county jail but granted such credit to those in state prison. The case is easily distinguishable on the facts, particularly since the prisoners in *McGinnis* were given "jail time" credit (i.e., the same type of credit sought in *Johnson*) for their presentence confinement. The legitimate state interest in denying credit for good time was found in the purpose of the good time program which was to award prisoners time credit for sufficient rehabilitative progress in the specifically designed programs that existed only at the state prison. As the *Johnson* court stated, no comparable basis was suggested in the instant case for articulating such a state

tion extending beyond that point is as invidious a discrimination as is a denial of credit for confinement beyond the statutorily imposed maximum.[42]

The *Johnson* court recognized that the Supreme Court's concern in *Williams* and its progeny was not solely with the indigent incarcerated longer than the statutory maximum term, but also with the indigent incarcerated longer than the defendant who is able to pay.[43] Thus the critical criterion is not, as the holdings of the Fifth and Ninth Circuits suggest, the relationship between the actual sentence imposed versus what the court *could* have imposed. Rather, the determinative relationship is that between the actual period of incarceration imposed on an indigent defendant unable to make bail and the actual period of incarceration imposed on a defendant similar in every respect *except* financial ability to post bail.

IV. The Presumption of Credit

A number of federal courts with decisions on point support the Seventh Circuit's holding in *Johnson* by asserting that equal protection is violated *whenever* the indigent's presentence confinement is not fully credited.[44] Some courts, however, have limited the impact of this proposition by holding that if the total period of incarceration is less than the statutory maximum, it is *presumed* that the sentencing court in fact credited the presentence time.[45]

Since in *Johnson* the appellants' aggregate jail time was less than the statutory maximum, the Seventh Circuit was obliged to determine whether, in the absence of a showing by the defendant that the presentence custody was not given the requisite consideration, a federal court in a habeas corpus action is justified in presuming that such credit was given. The viability of appellants' equal protection argument depended on whether the Seventh Circuit would adopt the presumption of credit.

A. Stapf v. United States: *The Origin of the Presumption*

The presumption of credit was first applied by the Court of Appeals for the District of Columbia Circuit in *Stapf v. United States,*[46] which involved a challenge to the constitutionality of the federal sentence-crediting statute, 18 U.S.C. § 3568.[47] In *Stapf,* although the petitioner's presentence confinement was

interest. Seldom is this factor of weighing a state interest of crucial importance when considering a failure to grant jail time credit for presentence confinement. It is generally felt that whereas the state has a legitimate interest in assuring the defendant's presence at trial, which provides a rational nexus for requiring incarceration in lieu of bail, once that presence has been assured no legitimate state interest is served by the denial of credit for time spent in such incarceration. Hypothesize the following example: Defendant A is financially capable of posting bail, and does so. Defendant B is indigent and thus unable to post bail; hence, he remains incarcerated awaiting trial. Upon appearing at trial Defendant A's bail money is returned. Should not Defendant B be "returned" his time?

42 *See generally* Note, *supra* note 31, at 588.

43 *Id.* at 587.

44 *See, e.g.,* Monsour v. Gray, 375 F. Supp. 786 (E.D. Wis. 1973); 516 F.2d 321; 471 F.2d 406; 351 F. Supp. 1012.

45 *See, e.g.,* 530 F.2d 1231; 449 F.2d 183; 465 F.2d 414; 496 F.2d 1172.

46 367 F.2d 326 (D.C. Cir. 1966).

47 Act of September 2, 1960, Pub. L. No. 86-691, § 1(a), 74 Stat. 738, *as amended,* 18 U.S.C. § 3568 (1970).

occasioned by his indigency, the district court for the District of Columbia had held that the federal statute did not require credit unless the defendant had been convicted of an offense that carried a minimum mandatory sentence. The statute provided in pertinent part: "The Attorney General shall give any such [federal prisoner] credit . . . for any days spent in custody . . . for want of bail . . . where the statute [under which he was sentenced] requires the imposition of a *minimum mandatory sentence.*"[48] The statute, since amended,[49] did not, however, expressly provide for credit to a defendant sentenced to a term under a lesser offense which did not require a mandatory minimum. Thus, Stapf, who had spent five months in presentence custody for want of bail and who was ultimately sentenced to the statutory maximum term, was not eligible for credit under § 3568 because he had been sentenced under an offense that did not carry a mandatory minimum.

The *Stapf* court, on appeal, examined § 3568's legislative history and concluded that although the credit granted by the statute was applicable only to minimum term offenses, Congress had intended that credit be granted to all defendants incarcerated due to inability to make bail.[50] Hence, in order to assure that the appropriate credit was given, the *Stapf* court held that federal courts must assume a duty to provide credit for *all* presentence custody occasioned by the defendant's indigency, where such credit would not otherwise be granted administratively due to the minimum mandatory sentence provision of the federal statute.[51]

The *Stapf* court's holding was not limited to maximum terms. It mandated crediting preconviction custody for want of bail to all federal sentences. The impact of the court's holding was limited, however, by the court's procedural qualification that:

> Wherever it is possible, as a matter of mechanical calculation, that credit could have been given, we will *conclusively* presume it was given. The problems and expenditures of resources which would be caused by allowing each prisoner to attempt to demonstrate that in his particular case credit was not given, we feel outweigh any possible unfairness.[52]

Thus, the court's holding required that in cases involving the federal statute, whenever the presentence confinement together with the actual sentence imposed did not exceed the statutory maximum, it would be *irrebuttably* presumed that credit had been given for presentence detention. Accordingly, other federal courts, including the Seventh Circuit, adopted and applied the *Stapf* presumption in subsequent cases involving § 3568.[53]

The amendment of the federal statute in 1966[54] to require the application

48 *Id.* (emphasis added).
49 *Id.* The statute was amended in view of the Supreme Court's decision in *Williams.*
50 367 F.2d at 328.
51 *Id.* at 330.
52 *Id.* (emphasis added).
53 *See, e.g.,* Holt v. United States, 422 F.2d 822 (7th Cir. 1970); Swift v. United States, 436 F.2d 390 (8th Cir. 1970), *cert. denied,* 403 U.S. 920 (1971). Some courts, however, refused to adopt the presumption as being conclusive. *See, e.g.,* United States v. Downey, 469 F.2d 1030 (8th Cir. 1972); Myers v. United States, 446 F.2d 232 (9th Cir. 1971).
54 *See* note 49 *supra.*

of all credit administratively, rather than judicially, obviated the necessity of the presumption with respect to federal prisoners. Federal courts, however, soon began to apply the presumption to habeas corpus actions brought by state prisoners.[55] These courts based their decisions upon the considerations of administrative expediency and judicial economy found compelling in *Stapf*.[56]

B. *The Use of the* Stapf *Presumption in a Constitutional Context*

The Seventh Circuit in *Johnson* confronted the question of whether the presumption of credit is appropriate where the claim for credit is constitutionally rather than statutorily based. The court had recently had an opportunity to decide this issue in *Faye v. Gray*.[57] The *Faye* court did not reach the issue, however, holding that even if application of the presumption were constitutional, it had been "clearly rebutted by the sentencing judge's own words."[58] *Faye*, however, is distinguishable from *Johnson* in that the trial judge in *Faye* clearly indicated in the record that he did not credit presentence time in sentencing the petitioner. The *Johnson* court faced a more difficult set of circumstances, particularly with respect to appellant Smith, because the record provided no such affirmative evidence.

The *Johnson* court focused primarily on the nature of the right asserted, and therein lies the importance of the court's holding as to the constitutional right to credit irrespective of whether the total imprisonment exceeds the statutory maximum. With respect to this right the court stated: "Were we to presume consideration, and therefore deny credit, that right would become illusory in many cases."[59]

In holding that no presumption, either conclusive or rebuttable, should apply in the constitutional context, the court contrasted its holding with that of the Fifth Circuit in *Parker v. Estelle*.[60] In *Parker* the Fifth Circuit held the *Stapf* presumption applicable in a habeas corpus action brought by a state prisoner. To distinguish the *Parker* court's holding, the Seventh Circuit focused on the absence of an assertion by the petitioner in *Parker* that his confinement had been occasioned by indigency or some alternative basis recognized as constitutionally impermissible by the Fifth Circuit.

In *Parker*, the defendant's presentence confinement in a state mental hospital was voluntarily imposed in lieu of trial for the offense charged. Found competent to stand trial six years later, the defendant was convicted and sentenced for the original offense, without, he alleged, receiving credit for time spent in the state hospital. On appeal, the Fifth Circuit conclusively presumed that the sentencing judge had given credit for the period of presentence custody in the state hospital, since the total period of confinement did not exceed the statutory maximum.

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55 Withers v. North Carolina 328 F. Supp. 1152 (W.D.N.C. 1971); 516 F.2d 321; 375 F. Supp. 786.

56 367 F.2d at 330. One commentator, however, has suggested that the presumption is not even the most appropriate device to enhance administrative convenience. Schornhorst, *supra*, note 40, at 1063.

57 541 F.2d 665.

58 541 F.2d at 699.

59 548 F.2d at 703.

60 498 F.2d 625.

Unlike the Seventh Circuit in *Johnson,* however, the Fifth Circuit had maintained since prior to its decision in *Parker,* that "there is no federal constitutional right to credit for time served prior to sentence."[61] The Fifth Circuit has since somewhat qualified that stance, in view of the Supreme Court's decisions in *Williams* and *Tate,* to hold that although there is no absolute right to presentence detention credit, a denial of such credit due to a defendant's poverty or some other constitutionally impermissible basis will not be allowed to extend his sentence beyond the maximum prescribed for the crime.[62] Without defining the scope of their intention with respect to "other constitutionally impermissible" bases, the *Parker* court made clear that the petitioner's confinement for medical treatment was not such a basis as would constitutionally require credit.[63]

Thus, as the *Johnson* court properly concluded, the *Parker* court's presumption of credit was predicated upon a factual situation in which the Fifth Circuit has never recognized a constitutional right of credit. Hence, the Fifth Circuit's holding on the presumption issue is clearly distinguishable from the Seventh Circuit's holding in *Johnson,* in which the presumption was held inapplicable in the context of a constitutional claim for credit.

The *Johnson* court's distinction of the Fifth Circuit's holding in *Parker* appropriately recognizes the impact of a constitutional basis for credit. Once established, the constitutional basis has the effect of solidifying the right. As one commentator has noted, "[i]f the claim to credit for pre-trial incarceration is of a constitutional right, then it is as impervious to judicial limitation as it is to statutory limitation; constitutional claims are not susceptible to defeat by exercise of a court's discretion."[64]

Moreover, the *Stapf* presumption, when applied to constitutional claims for sentence credit, has never been accorded the conclusiveness associated with its statutory application.[65] In *King v. Wyrick,*[66] a case cited by the *Johnson* court, the Eighth Circuit questioned the applicability of the *Stapf* presumption to a constitutional claim for credit, and, although deferring a decision on the continuing existence of the presumption, held that in any event the presumption is not applicable when the record clearly indicates that credit was not given.[67] Similarly, in *Monsour v. Gray,*[68] the only other federal case of continuing authority where the *Stapf* presumption was considered in the context of a constitutional claim, the District Court for the Eastern District of Wisconsin recognized the presumption but held it sufficiently rebutted in light of the trial judge's indication that he had not given credit. Thus, other federal courts have rejected at least the *irrebuttable* nature of the *Stapf* presumption, while deferring a decision on the presumption's continued existence in the context of a constitutional claim for credit.

61 *Id.;* 425 F.2d 1293.
62 498 F.2d at 627; *accord,* 449 F.2d 183; 465 F.2d 414.
63 498 F.2d at 627.
64 Stacy, *Constitutional Right to Sentence Credit for Pre-trial Incarceration,* 41 UNIV. OF CINN. L. REV. 823, 825 (1972).
65 *See* 516 F.2d 321; 375 F. Supp. at 788. These decisions reject the application of any presumption when the record clearly indicates that credit was not given.
66 516 F.2d 321.
67 *Id.* at 324.
68 375 F. Supp. 786.

Although not expressly relied upon by the *Johnson* court, *North Carolina v. Pearce*[69] provides additional support for the Seventh Circuit's decision. In *Pearce* the Supreme Court was concerned with the possibility of a retaliatory element being a factor in a defendant receiving a more severe sentence when reconviction follows a successful appeal. Accordingly, the Court held enhanced punishment upon reconviction constitutionally permissible only if premised upon new and relevant information concerning the defendant.[70] An extrapolation of the *Stapf* logic would call for the Supreme Court to implement the standard with a presumption by the reviewing court that any increased punishment was due to the discovery of such new factors by the trial court. Instead the *Pearce* court developed a reverse presumption, placing the burden of proof on the trial court:

> In order to assure the absence of [retaliatory] motivation, we have concluded that whenever a judge imposes a more severe sentence upon a defendant after a new trial, the reasons for his doing so must affirmatively appear . . . And the factual data upon which the increased sentence is based must be made part of the record, so that the constitutional legitimacy of the increased sentence may be fully reviewed on appeal.[71]

The *Pearce* Court thus refused to tolerate an evidentiary rule that had the effect of "presuming away" an individual's constitutional rights. Analogously, but without reference to *Pearce,* the Seventh Circuit reasoned that the defendant's constitutional right to presentence credit should be accorded similar deference.[72]

The *Johnson* court was not unanimous, however, with respect to the presumption issue. In his dissent, Judge Campbell stated, without citing support, that it was both constitutional and desirable to at least "rebuttably" presume that credit had been given, and to impose upon the petitioner the burden of proving to the contrary.[73] In light of the *Pearce* analogy and basic evidentiary theory,[74] however, Judge Campbell's proposal with respect to a constitutional claim for credit appears deficient. As the majority stated with regard to their conclusion that the burden of proof should rest with the state rather than the petitioner, "[a]n opposite result would derogate from the importance of the equal protection right to have presentence jail time [credited] at the time of sentencing . . . ."[75] In this context any presumption whether rebuttable or conclusive, will deprive the petitioner of a reasonable opportunity to prove his case. Consistent with the majority's shift of the burden to the state is the evidentiary axiom that the state rather than the convicted offender should bear the burden of proving whether credit was given, since it is the former who has the peculiar means of knowledge necessary to prove the truth of the allegation.[76] Since indigent offenders are the least capable of employing the means to rebut the presumption, requiring these persons to prove the truth of their allegations of non-credit effectively denies them all chances of obtaining relief.[77]

69 395 U.S. 711 (1969).
70 *Id.* at 726.
71 *Id.*
72 *See* text accompanying note 75 *infra.*
73 548 F.2d at 704 (Campbell, J., concurring in part and dissenting in part).
74 *See* text accompanying note 77 *infra.*
75 548 F.2d at 703.
76 *See* 9 J. WIGMORE, EVIDENCE § 2486 at 275 (3d. ed. 1940).
77 *See* Bandini Co. v. Superior Court, 284 U.S. 8 at 19 (1931).

C. *The Absence of a Proven Fact Upon Which to Base the* Stapf *Presumption*

Without regard to the constitutional context crucial in the instant case, it is fundamental that any judicial presumption must rest on a factual basis. The Supreme Court established a standard for such presumptions in *Leary v. United States*:[78] "[A] presumption must be regarded as 'irrational' or 'arbitrary' and hence unconstitutional, unless it can at least be said with substantial assurance that the 'presumed' fact is more likely than not to flow from the 'proved' fact on which it is made to depend."[79] Similarly, one commentator has stated in criticizing the irrebuttable *Stapf* presumption: "[T]he major defect in this presumption is [that] the ['proved'] fact as to the existence of such a judicial practice [of crediting] is at best an unsupported assertion."[80]

Application of these evidentiary standards to the instant case supports the *Johnson* court's decision. There was no "proven" fact upon which the *Johnson* court could presume that the Wisconsin trial judge had given the appellants credit. At the time of Johnson's sentencing Wisconsin had neither statutory provision nor case law that required such credit to be given. The Wisconsin Supreme Court had ruled that pretrial detention was "merely a proper factor" to consider in exercising judicial discretion in sentencing and that in the absence of a showing that the maximum term had been exceeded, a sentencing judge was not required to grant credit for pretrial incarceration.[81]

A further basis tacitly asserted in support of the *Stapf* presumption is a preliminary presumption that the sentencing judge is cognizant of the presentence detention that each defendant has endured.[82] This suggests that the sentencing judge is intimately involved and familiar with each criminal case from beginning to end. Yet under Wisconsin law it is unlikely that a convicted defendant will be sentenced by the judge most familiar with the conditions of his presentence confinement. In Wisconsin, bail is set by a judge at an initial appearance,[83] after which the case is normally transferred to a different judge for preliminary hearing.[84] The preliminary hearing judge in turn must transfer the case again for arraignment and trial, unless the prosecution and defense waive that right.[85]

78 395 U.S. 6 (1969). In *Leary*, the Court was concerned with a statutory presumption. A judicial presumption, however, should be subject to the same scrutiny as a statutory presumption in ascertaining the connection between the known and the presumed fact. *See, e.g.*, United States v. Barnes, 412 U.S. 837, 845 n.8 (1973).

79 395 U.S. at 36.

80 Schornhorst, *supra* note 40, at 1064.

81 Hall v. State, 66 Wis. 2d. 630, 633-634, 225 N.W. 2d. 493, 495 (1975). In *Hall*, the Wisconsin Supreme Court clarified its earlier holding in Byrd v. State, 65 Wis. 2d. 415, 222 N.W. 2d 696 (1974). *Byrd* suggested that presentence detention could be considered in imposing a sentence which, when added to the presentence time, did not exceed the statutory maximum. The *Hall* court made clear, however, that *Byrd* did not make mandatory a credit under such circumstances, nor would a failure to grant such credit amount to a denial of equal protection. Subsequent to the Seventh Circuit's decision in *Johnson*, the Wisconsin Supreme Court handed down its decision in Klimas v. State, 75 Wis. 2d 244, 249 N.W. 2d. 285, in which the court held that all periods of presentence custody occasioned by indigency are constitutionally entitled to credit.

82 *But see* Hearings on Federal Bail Procedures Before Subcomm. of the Senate Comm. on the Judiciary, 89th Cong., 1st Sess. (1965) (where federal trial judge admits to frequently forgetting, or not knowing that defendant has been in pre-trial confinement).

83 WIS. STAT. § 970.02(2) (1973).

84 *See* WIS. STAT. § 970.02(5) (1973).

85 WIS. STAT. § 971.21 (1973).

In addition, the defense has the right of one preemptory substitution of the trial judge.[86]

Thus, the potential unfamiliarity of the sentencing judge with the time spent by the defendant in presentence custody, together with the absence of statutory mandate or judicial precedent requiring credit for presentence detention, undermines the asserted factual foundation of the presumption. In *Johnson* there was absolutely no "proven" fact from which the court could be "substantially assured" that the "presumed" fact, *i.e.*, that credit had been given, would be "more likely than not to flow."[87]

Wisconsin, however, is one of a small number of states that do not statutorily require credit for presentence confinement. Several states now provide either statutorily or by judicial proclamation for at least some form of credit.[88] Although such mandates do not necessarily assure that credit will always be given, they do provide a minimum basis for some regularity in judicial practice. Hence the *Johnson* court's holding, shifting the entire burden of proof to the state to show that credit was given, might not be appropriate in all jurisdictions. In those jurisdictions that require the sentencing judge to grant credit, in the absence of some evidence to the contrary at least some presumption of judicial regularity might be appropriate. The state does not have the burden of proving that all constitutional rights in the criminal process have been observed. Thus, without disparaging the constitutional right to credit, courts following the *Johnson* rationale may seek some middle ground between the *Stapf* presumption and the *Johnson* court's shift of the entire burden to the state.

V. Double Jeopardy: A Broader Approach to the Credit Issue

The equal protection analysis set forth by the *Johnson* court clearly mandates credit for presentence confinement when such confinement was occasioned by indigency. However, if such detention is occasioned by the petitioner's ineligibility for bail as, for example, a parole violator or as one held on a capital charge, the ban against multiple punishment implicit in the fifth amendment's double jeopardy provision is analytically more appropriate. In equal protection analysis, recidivism and commission of a grave offense may represent rational criteria for treating those offenders differently.[89] Notwithstanding such "rational" criteria, however, the denial of credit to these offenders poses as much a constitutional issue as does the denial of credit to an indigent defendant.

Johnson argued in the alternative for credit on the basis of double jeopardy. The Seventh Circuit thus had an opportunity to address that issue and broaden the scope of its holding. Nonetheless, the court avoided the issue by stating that its prior holding in *Faye v. Gray* precluded relief on that basis. The Seventh

86 *See* WIS. STAT. § 971.20 (1973).

87 *See* 395 U.S. at 36; United States v. Barnes, 412 U.S. 837, 845 n.8 (1973).

88 States having a statute in Seventh Circuit include: ILL. ANN. STAT. Ch. 37 § 1005-8.7 (Smith-Hurd 1973) (full credit); IND. CODE ANN. § 35 8.1-16 (Burns 1975) (partial credit). Although Wisconsin does not statutorily grant credit, the Wisconsin Supreme Court's recent decision in *Klimas* indicates that credit will be required in the future. *See* note 81 *supra*.

89 *See* note 41 *supra*, for a discussion of the traditional equal protection analysis as applied to sentence crediting claims.

Circuit in *Faye* held that "a failure to grant credit violates the guarantee against double jeopardy [*only*] when the presentence time together with the sentence imposed is greater than the statutory maximum for the offense."[90] While the Seventh Circuit's disposition of the instant case is certainly consistent with *Faye,* it should be noted that the *Faye* decision itself is constitutionally suspect.

The *Faye* court's reliance on the statutory maximum rationale is inconsistent with the Supreme Court's holding in *North Carolina v. Pearce.*[91] In *Pearce,* the Supreme Court asserted that the basic tenets of the fifth amendment's guarantee against double jeopardy consist of three separate constitutional protections. The threefold protection, as stated by the Court, prohibits a second prosecution for the same offense after acquittal,[92] as well as a second prosecution for the same offense after conviction.[93] Further, it protects against *multiple punishments* for the same offense.[94] The latter protection is necessarily implicated in any consideration of the question of a constitutional right to credit for presentence confinement.[95] The *Pearce* Court held that double jeopardy is violated "whenever punishment already exacted for an offense is not fully credited in imposing sentence . . . for the same offense."[96]

In *Pearce,* the defendant's successful post-conviction appeal had resulted in the reversal of a conviction for which he had already served time. Upon retrial, the defendant was again convicted and sentenced to a term which, when added to the time he had already spent in prison, amounted to a longer total sentence than originally imposed. The basis of the Supreme Court's concern was not with the multiple convictions, but with the element of dual punishment resulting from a denial of credit for time previously served for the same offense. In fact it was the double punishment issue and not the double conviction issue upon which the *Pearce* Court based its double jeopardy holding.[97] Accordingly, federal courts have interpreted *Pearce* as not limited to situations involving double prosecutions and have applied the rationale in a variety of single prosecution situations.[98]

Although *Pearce* was decided in the context of a total period of confine-

90 541 F.2d at 667 (emphasis added).
91 395 U.S. 711.
92 *Id.* at 717 (citing Green v. United States, 355 U.S. 184 (1957)).
93 *Id.* (citing In re Nelsen, 131 U.S. 176 (1888)).
94 *Id.* (citing United States v. Benz, 282 U.S. 304, 307 (1930)).
95 The multiple punishment argument as applied to claims of credit for presentence confinement can best be illustrated by the following example. Suppose that two defendants, Jones and Smith, are arrested and charged with the same offense. The offense carries a maximum sentence of 1 year. Jones posts bond and is released pending the outcome of his trial, but Smith remains in custody. Three months after the date of their arrest, both are convicted and sentenced. The sentencing judge determines that in both cases an appropriate sentence is six months. Thus, Smith's total time of detention remains within the statutory maximum. Nevertheless, unless the sentencing judge credits Smith's presentence time, he will spend a total of nine months in custody, whereas Jones will spend only six months. Since the sentencing judge determined that six months was an appropriate sentence (as substantiated by Jones' sentence), the extra three months Smith must endure is tantamount to "multiple punishment." Smith has served in excess of the period determined by the sentencing judge as sufficient to satisfy the state's penal interest. *See* 52 NOTRE DAME LAW. 393, 400, n.43.
96 395 U.S. at 718, 719.
97 *See* 395 U.S. at 718, 719.
98 *See, e.g.,* Wilson v. North Carolina, 438 F.2d 284 (4th Cir. 1971); Wright v. Maryland, 429 F.2d 1101 (4th Cir. 1970); Durkin v. Davis, 390 F. Supp. 249 (E.D. Va. 1975), *rev'd on other grounds,* 538 F.2d 1037 (4th Cir. 1971); 449 F.2d 183.

ment which exceeded the statutory maximum, the Supreme Court made clear that the guarantee against double jeopardy excludes multiple punishments *per se,* not simply multiple punishments which in combination exceed the statutory maximum.

The *Pearce* Court held that the constitutional violation was "flagrantly apparent" and "dramatically evident" in cases involving incarceration in excess of the statutory maximum, but noted that the same principle was equally applicable whenever punishment already endured is not fully subtracted from any sentence ultimately imposed.[99]

Relative to whether punishment had already been "endured," the *Johnson* court, in discussing the equal protection issue, expressly stated that "[t]he judge must view [presentence] custody as punishment imposed for the offense."[100] Thus, the Supreme Court's *Pearce* standard renders untenable the *Faye* court's insistence that the aggregate incarceration must exceed the statutory maximum before a double jeopardy claim may be raised. As a result, the Seventh Circuit's reliance on *Faye* in dismissing Johnson's double jeopardy argument is equally untenable.

The *Faye* court's erroneous interpretation of *Pearce* resulted from the court's acceptance of *Culp v. Bounds*[101] as support for its holding. In *Culp,* the federal district court, citing *Pearce,* held that North Carolina's failure to credit the petitioner for presentence confinement when the total period of incarceration exceeded the statutory maximum, constituted double punishment for a single offense and thereby offended the double jeopardy clause of the fifth amendment. Although the *Culp* court implicitly limited its construction of *Pearce* to presentence confinement which extends the total period of confinement beyond the statutory maximum, the court explained its restrictive interpretation:

> The court assumes, without deciding, that where the time spent in custody before commitment when added to the sentence given after trial is *less* than the statutory maximum, no constitutional issue is presented. In that situation, this court . . . is reluctantly inclined to indulge the fiction that the trial judge who imposes the sentence has given the defendant credit for time served before commitment.[102]

Thus the court in *Culp* explained its reasoning for not applying the double jeopardy argument when the total incarceration does not exceed the statutory maximum as a reluctant acceptance of the judicial presumption of credit. In *Johnson,* however, the Seventh Circuit has expressly ruled that such a presumption is inappropriate in the context of a constitutional claim for relief. Yet in *Johnson* the Seventh Circuit reaffirmed its acceptance in *Faye* of the district court's decision in *Culp* as support for rejecting Johnson's double jeopardy argu-

99 395 U.S. at 718.

100 548 F.2d at 702. *Accord* 538 F.2d at 1041 ("pretrial detention is nothing less than punishment").

101 325 F. Supp. 416 (W.D.N.C. 1971).

102 *Id.* at 419. The district court in *Culp* cited Withers v. North Carolina, 328 F. Supp. 1152 (W.D.N.C. 1971), as support for its application of the presumption to a double jeopardy claim. Although *Withers* was an equal protection case, the *Culp* court's reference to that decision indicates that the ultimate source of the presumption used in *Culp* was the *Stapf* presumption itself.

ment. Hence it is evident that the Seventh Circuit's treatment of the constitutional bases for credit is in conflict. While rejecting any presumption of credit in the context of equal protection, it simultaneously applied the identical presumption to refute the appellant's double jeopardy argument. This inconsistent treatment of the double jeopardy argument compounds the error of the Seventh Circuit in summarily dismissing the issue of whether an assertion of double jeopardy is appropriate in a claim for credit for presentence confinement.

By mechanically following its prior double jeopardy holding in *Faye,* the *Johnson* court forfeited sound judicial reasoning. More importantly, the court's failure to reevaluate its position on double jeopardy in light of its general holding on the presumption issue needlessly left unanswered the non-indigent defendant's constitutional right to credit for presentence confinement.

VI. Conclusion

In *Johnson* the Seventh Circuit addressed two specific issues. In the first, they followed a small but growing number of federal decisions in extending the *Williams* doctrine to require credit for *all* periods of presentence confinement occasioned by indigency. Although this is a significant development in itself, it assumes even greater importance in providing an appropriate context for the court's decision on the presumption issue.

In considering the presumption issue, the *Johnson* court met head-on those courts which recognize the indigent's right to credit for presentence confinement yet dilute the right by the use of a poorly reasoned judicial presumption. In holding the presumption inapplicable in the context of a constitutional claim for credit, the *Johnson* court significantly strengthened the constitutional right itself.

From a policy standpoint the *Johnson* court's holding on the presumption issue is important. In the absence of sorely needed legislation requiring clearly reasoned sentencing statements, the *Johnson* court's holding should indirectly prompt state sentencing judges to take that initiative. Having made their holding retroactive,[103] the *Johnson* court's decision is likely to cause an increase in

103 In response to the Wisconsin Supreme Court's decision in *Klimas,* (*see* note 81 *supra*), the Seventh Circuit issued a supplement to their opinion in *Johnson.* The court clarified, without discussion, what it had intimated before, and held that *Johnson* was to have retroactive application. The Supreme Court in Stovall v. Denno, 388 U.S. 293, 297 (1967), stated the criteria to be used guiding the question of the retroactivity of a holding of unconstitutionality. The criteria are threefold:

1. the purpose to be served by the standards;
2. the extent of the reliance by law enforcement authorities on the old standards; and
3. the effect on the administration of justice of a retroactive application.

Having not elaborated on their decision, it seems apparent that the *Johnson* court felt the purpose to be served (i.e., individual liberty) was more important than the administrative burden. At least one federal court has held the double jeopardy principles espoused in *Pearce* to have retroactive application in claims for sentence credit. *See* Allen v. Henderson, 434 F.2d 26 (5th Cir. 1970). A potential difficulty with the Seventh Circuit's decision is that the Wisconsin Supreme Court gave *Klimas* only prospective application. Although the *Johnson* court indicated that carrying out the retroactive ruling could be done administratively by the state, this is unlikely, since generally no legal authority exists for administrative modification of a sentence valid under state law. Furthermore, until the United States Supreme Court has spoken, state courts are not precluded from exercising their own judgment on questions of federal law. *See* United States ex rel. Lawrence v. Woods, 432 F.2d 1072, 1075-76 (7th Cir. 1970), *cert. denied,* 402 U.S. 983 (1971). Thus, the conflicting rulings of the *Klimas* and *Johnson* courts are likely to put a substantial burden on the federal district courts in Wisconsin. For more on the retroactivity issue, *see generally* Schornhorst, *supra* note 40, at 1074; Stacy, *supra* note 64, at 835.

sentence credit claims, which in turn should encourage state sentencing judges to state unambiguously on the record whether such credit was given when sentence was imposed.

Troubling, however, was the court's inconsistent treatment of the constitutional bases for credit. In summarily dismissing the appellant's assertion of an alternative basis for credit, the *Johnson* court unnecessarily narrowed the scope of its holding to include only indigent defendants. The court was presented with an opportunity to remedy the inherent injustice worked upon any defendant whose presentence confinement is not duly credited. Although the present bail system is arguably a necessary "evil," a denial of credit for incarceration so occasioned presents an issue of constitutional concern. The Seventh Circuit's holding to the contrary notwithstanding, that concern is not limited to individuals incarcerated as a result of their indigency.

Whatever the Seventh Circuit's ultimate position on the applicability of the double jeopardy argument to the sentence crediting issue, it is clear that the court must reconsider its position in light of its decision in *Johnson* as to the inappropriateness of a presumption of credit. Only then can the Seventh Circuit address the more central issue of a constitutional right to credit for all defendants incarcerated prior to trial and sentencing.

James P. Kelley

EQUAL PROTECTION—Equal Protection Requires that Municipality Accord Equal Treatment to Ex-Offenders in Granting Public Chauffeurs' Licenses.

*Miller v. Carter**

I. Introduction

The equal protection and due process clauses of the fourteenth amendment are employed by courts to examine state and municipal laws which establish and regulate specific classes of persons. In such examinations, the line of demarcation between the two clauses often becomes uncertain.[1] In *Miller v. Carter*,[2] the Seventh Circuit demonstrated the close interplay between equal protection and due process in striking down a municipal ordinance which denied public chauffeurs' licenses to certain ex-felons.

The plaintiff in *Miller* had been convicted of armed robbery in 1965. After serving seven years in state prison and completing his parole, he applied to Chicago's Public Vehicle Licensing Commission for a public chauffeur's license. Such a license is necessary to qualify for employment as a taxi or bus driver. His application was refused under a Chicago ordinance which barred certain ex-offenders from obtaining such licenses.[3]

Plaintiff challenged the constitutionality of the ordinance in the United States District Court for the Northern District of Illinois, seeking injunctive and declaratory relief. The district court granted the motion of the defendant, Chicago's Public Vehicle Licensing Commissioner, to dismiss the complaint for failure to state a claim.

On appeal, plaintiff attacked the constitutionality of the ordinance on two grounds. First, he contended that the city's legislative scheme violated equal protection by discriminating among the class of ex-offenders. Ex-offenders applying for a license were automatically rejected, while licensees convicted of the same offenses were given the benefit of discretionary review on their status as licensees.[4] Second, plaintiff argued that the ordinance which barred his application violated due process by creating an irrebuttable presumption of unfitness.

In finding the ordinance to be unconstitutional, the Seventh Circuit departed from traditional equal protection doctrine by employing a more rigid standard of review than that which is normally employed in similar cases. Unfortunately, the Court bypassed a more viable method, a due process analysis, to achieve this more rigid standard. This comment will show that the Seventh

* 547 F.2d 1314 (7th Cir.), *cert. granted*, 97 S.Ct. 1643 (1977).

1 *See* Note, *Irrebuttable Presumptions: An Illusory Analysis*, 27 Stan. L. Rev. 449 (1975); Note, *The Conclusive Presumption Doctrine: Equal Process or Due Protection?*, 72 Mich. L. Rev. 800 (1974).

2 547 F.2d 1314.

3 Chicago, Ill., Mun. Ordinances, Ch. 28.1-3, which reads, in part, that no such license shall "be issued to any person at any time after conviction of a crime involving the use of a deadly weapon, traffic in narcotic drugs, the infamous crime against nature, incest, or rape."

4 Chicago, Ill., Mun. Ordinances, Ch. 28.1-10 "[T]he commissioner may recommend to the mayor that (the) license be revoked and the mayor, in his discretion, may revoke such license."

Circuit did not afford the discretion to legislative judgments normally given under the equal protection/rational relation standard. It will also show that a due process test, the irrebuttable presumption doctrine, should have been applied in *Miller*.

II. Equal Protection

A. *Standard of Review*

In considering the equal protection issue, the Seventh Circuit compared the treatment by the city's ordinances of ex-offenders who applied for licenses[5] with that of existing license holders who had been convicted of the same offenses.[6] The court considered whether the blanket exclusion of ex-offender applicants, coupled with the discretionary review allowed to ex-offender license holders, was valid under the equal protection clause. In doing so, the Seventh Circuit had to choose between the strict scrutiny and rational relation standards of review. The court chose the rational relation test and concluded that the ordinance was not rationally related to its goals and was, therefore, invalid.

In disposing of the equal protection issue under this rational relation standard, the Seventh Circuit, although it never discussed the question, apparently found that the strict scrutiny rule did not apply to the facts in *Miller*.[7] This rule is applied when suspect classifications[8] or fundamental rights[9] of the litigants are involved. Under strict scrutiny, the legislation will be upheld only if there is a compelling state reason for its existence.[10]

Although plaintiff had argued that his right to seek work as a cab driver was fundamental, case law mandated a contrary conclusion. After the Supreme Court's decision in *Massachusetts Bd. of Retirement v. Murgia*,[11] plaintiff's right to seek work as a taxi driver cannot be considered a fundamental one. Although Judge Campbell's concurring opinion in *Miller* labelled this right as important,[12] the Supreme Court in *Murgia* refused to accord the right to work the status of a fundamental right.

Similarly, although the class of ex-offenders may possess some of the traditional indicia of suspectness previously enumerated by the Supreme Court, felons have never been labelled a suspect class. In *San Antonio School District v. Rodriguez*,[13] the Supreme Court described a suspect class as one "saddled with

5 CHICAGO, ILL., MUN. ORDINANCES, Ch. 28.1-3.
6 CHICAGO, ILL., MUN. ORDINANCES, Ch. 28.1-10.
7 Although the Seventh Circuit never explicitly stated which test it was using, the opinion did use the language of rational relation in invalidating the ordinances. "Accordingly, insofar as Ch. 28.1-3 and 28.1-10 discriminate irrationally among the class of ex-offenders, they violate the Equal Protection clause of the Fourteenth Amendment." 547 F.2d at 1316.
8 Examples of suspect classes are alienage (Graham v. Richardson, 403 U.S. 365 (1971)); race (Loving v. Virginia, 288 U.S. 1 (1967)); and ethnicity (Oyama v. California, 332 U.S. 633 (1948)).
9 *See* Roe v. Wade, 410 U.S. 113 (1973); right to privacy (Bullock v. Carter, 405 U.S. 132 (1972)); right to vote (Shapiro v. Thompson, 394 U.S. 618 (1968)); right to interstate travel (Williams v. Rhodes, 393 U.S. 23 (1968)); first amendment rights (Skinner v. Oklahoma ex rel. Williamson, 316 U.S. 535 (1942), right to procreate.
10 *See, e.g.*, Shapiro v. Thompson, 394 U.S. 618 (1968).
11 425 U.S. 307 (1976).
12 547 F.2d at 1328.
13 411 U.S. 1 (1973).

such disabilities or subjected to such a history of purposeful unequal treatment, or relegated to such a position of political powerlessness"[14] as to require special protection. Although this description may seem applicable to felons, status as a felon is not a characteristic acquired at birth, as is race or nationality. The latter two bases of classification are among those which have been deemed to require the extraordinary judicial protection of the strict scrutiny rule.[15]

Since the Seventh Circuit apparently concluded that the strict scrutiny rule was inapplicable to *Miller,* the court employed the rational relation standard. The rational relation test is used in equal protection cases in which suspect classes or fundamental rights are not involved. This lower standard of constitutionality requires only a showing that "the system bear some rational relationship to legitimate state purposes."[16]

By concluding that the city's ordinances were not rationally related to the goals of public safety, the Seventh Circuit demonstrated the uncertain boundaries between fourteenth amendment equal protection and due process. In a similar case, *Freitag v. Carter,*[17] the Seventh Circuit found a Chicago ordinance which barred individuals with a history of mental illness from receiving public chauffeurs' licenses to be violative of due process. The *Freitag* court required that hearings be provided to such applicants to allow them an opportunity to demonstrate their fitness. The *Miller* court concluded that merely providing a hearing to ex-offender applicants would be an ineffective remedy. Since Ch. 28.1-3 would require the Commissioner to deny the application of any ex-offender, the hearing would be a mere formality.[18] Since the Seventh Circuit could not prevent the automatic denial of the ex-offender's application through a due process analysis, the court employed a stricter rational relation standard than that normally used.

B. Miller: *A Stricter Standard*

In examining *Miller,* the Seventh Circuit curtailed the traditional deference to legislative judgments normally afforded under the rational relation standard. Under this standard, legislatures are not required to draw classifications with mathematical precision, but are accorded a fair measure of latitude.[19] Statutory distinctions are normally upheld if any state of facts may reasonably be conceived to justify them.[20]

A recent example of this judicial deference to legislative judgments is the *Murgia* decision. The Supreme Court applied the rational relation test to examine a state statute mandating the retirement of police officers at age fifty. Although the Court conceded that the method chosen to insure the fitness of older police officers was not foolproof, the statute was found to be ra-

14 *Id.* at 28.
15 This was the conclusion of Judge Campbell's concurring opinion. 547 F.2d at 1320-21.
16 San Antonio School District v. Rodriguez, 411 U.S. at 40.
17 489 F.2d 1377 (1973).
18 547 F.2d at 1315.
19 *See, e.g.,* Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307 (1976); Dandridge v. Williams, 397 U.S. 471 (1970).
20 *See, e.g.,* McGowan v. Maryland, 366 U.S. 425 (1961).

tionally related to the goals of public safety. The Court's finding of a rational relation between the statute and the goal of public safety dispensed with the need for Court approval of all the legislative details. Although the state's plan was not precisely drawn, it was not found to be irrational. Therefore, no further inquiry was necessary under the rational relation test.

Instead of allowing Chicago to exercise such discretion in fashioning its ordinances, the Seventh Circuit required that the city address the problem as an exclusive proposition. Either all ex-offenders, licensees and applicants, must be automatically barred from driving for the public or no ex-offenders must be so barred. Discretion in drawing the classifications, the traditional legislative function, is not permitted.

Such exclusive treatment conflicts with the normal policy of deference to legislative judgments. The Seventh Circuit ignored this discretion in two ways in *Miller*. First, the Court did not directly address the relevance of prior convictions to an individual's fitness to drive a cab. This is important in considering the rationality of the ordinances. Judge Campbell's concurring opinion considered the exclusion of the ex-offender applicant on this basis and concluded that exclusion is rational.[21] Second, the Seventh Circuit brusquely discounted the city's argument that an individual determination is more efficacious in the case of the ex-offender licensee. The city had argued that the licensee has a past history with the city against which his offense can be considered.

Instead of considering whether this "track record" argument is a reasonable justification for the differential treatment of licensees and applicants, as the rational relation test would require, the Seventh Circuit questioned the rationality of permitting the ex-offender licensees to continue driving in the most egregious cases. For example, the court concluded that it would be irrational to allow an individual to continue driving after committing an offense if his license was issued one day before his conviction. Such an offender would have no performance record which the city could use in evaluating his fitness.

In this analysis, the Seventh Circuit focused upon the wrong issue. The court should have applied the rational relation test to determine if there was a logical reason for the differential treatment. It should have been irrelevant that in some extreme hypothetical cases the process might achieve an unsatisfactory result. Plaintiff had argued that allowing review for the licensee and not the applicant was violative of equal protection. The proper question, then, was whether a state of facts may reasonably be stated to justify the exercise of discretionary review for the licensee, not whether such review would hypothetically permit the city to abuse the process.

The approach of the Seventh Circuit in *Miller* restricts the leeway normally accorded to legislative judgments in the selection of remedies. In a previous equal protection case, the Supreme Court explained that the reason for this deference is that "(e)vils in the same field may be of different dimensions and proportions, requiring different remedies."[22] Legislatures are permitted to move "one step at a time"[23] in dealing with such situations.

21 547 F.2d at 1322.
22 Williamson v. Lee Optical Co., 348 U.S. 483, 489 (1955).
23 *Id.* at 489.

Although courts have most often applied this doctrine of legislative discretion in the framework of economic and social welfare cases, the doctrine is not limited to those areas. In *Murgia,* the underlying goal of the legislation was to enhance public safety. The statute sought to insure the physical fitness of police officers in order to provide the public with proper protection from crime.[24] By upholding the statute, the Supreme Court allowed the legislature to exercise discretion in the selection of a remedy to provide for public safety. As previously discussed, the fact that the statute was found to be rational resolved any constitutional doubts over the imperfection of the remedy chosen.

In a similar fashion, Chicago should have been granted some measure of latitude in providing different mechanisms to protect the public safety at different stages in the licensing process. The rational relation standard requires only that a state of facts can be reasonably conceived to justify the differential treatment. The Seventh Circuit did not forthrightly discuss this issue.

Instead, the Seventh Circuit chose to rely on the *Freitag* decision. As stated earlier, *Freitag* binds the Seventh Circuit to provide some type of hearing to the ex-offender applicant. This review is effectively blocked by Ch. 28.1-3. In order to achieve a result in *Miller* which is similar to that in *Freitag,* the Seventh Circuit curtailed the traditional deference to legislative judgments by making the equal protection standard more rigid.

By utilizing this analysis, the Seventh Circuit's handling of *Miller* approached the standard of equal protection advocated by Justice Marshall and others.[25] In his dissent in *Murgia,* Justice Marshall summarized his past criticisms of the strict scrutiny/rational relation dichotomy. Under this approach, according to Marshall, the preliminary choice of the applicable standard is usually determinative of the case. When strict scrutiny is applied, the legislation is invalidated. When a rational relation test is used, the legislation is normally found to be constitutional. Marshall would prefer the focus of the inquiry in all equal protection cases to be "upon the character of the classification in question, the relative importance to individuals in the class discriminated against of the governmental benefits that they do not receive, and the state interests asserted in support of the classification."[26] This standard would provide the courts with greater flexibility by allowing a balancing of the above factors without binding the courts to allow great legislative discretion in cases not involving a strict scrutiny rule.

Although the Seventh Circuit used the rhetoric of the rational relation test, it refused to accord the traditional deference to legislative judgments. The court, however, may have implicitly adopted Marshall's standard and asked "whether there is an appropriate governmental interest suitably furthered by the differential treatment."[27] Further credence is lent to this interpretation of *Miller* by the conspicuous absence of any discussion of the applicability of the strict scrutiny rule

24 "The primary function of the Uniformed Branch of the Massachusetts State Police is to protect persons and property and maintain law and order." 427 U.S. at 310.

25 *See* Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307 (1976) (Marshall, J., dissenting); Vlandis v. Kline, 412 U.S. 441 (1973) (White, J., dissenting); Gunther, *The Supreme Court, 1971 Term, Foreword: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection,* 86 HARV. L. REV. 1 (1972).

26 Massachusetts Bd. of Retirement v. Murgia, 427 U.S. 307, 318 (1976) (Marshall, J., dissenting).

27 Police Department of Chicago v. Mosley, 408 U.S. 92 (1972).

in the Court's opinion.[28] Such an inquiry would be irrelevant under Marshall's rationale.

III. Due Process

A. *The Irrebuttable Presumption Standard*

The more rigid review of legislative action which the Seventh Circuit sought could have been more expeditiously achieved through use of a due process analysis. This was the thrust of Judge Campbell's concurring opinion. Judge Campbell feared that the court's opinion would give rise to future litigation in the event that the city removed the equal protection problem by amending the ordinances to totally bar all ex-offenders.[29] Therefore, in considering the constitutionality of barring ex-offender applicants he used a due process analysis which had been used in prior irrebuttable presumption cases. Because of recent developments in the law, however, the Seventh Circuit expressed doubt over the continued vitality of the irrebuttable presumption doctrine of the due process clause. As will be shown, *Miller* is a case more properly decided on due process grounds.

The plaintiff had argued that the ordinance which barred his application created an unconstitutional irrebuttable presumption of unfitness. The ordinance conclusively presumed that, as an ex-offender, he was unfit to drive a taxi. There existed no process by which he could refute this conclusion. Therefore, he contended that he was deprived without due process of the ability to obtain a license.

As in the rational relation test of equal protection, the initial inquiry into the constitutionality of such a presumption is one of rationality. This inquiry examines whether a rational relationship exists between the known fact, *e.g.,* plaintiff's status as an ex-offender, and the presumed fact, his unfitness to drive a cab.[30] The close relationship between equal protection and due process is again apparent. Both share the same basic inquiry into the rationality of the legislative classifications.

Under the irrebuttable presumption test, however, a party who challenges the constitutionality of a presumption may prevail even though the relationship between the known and presumed facts is not so disparate as to fail the rational relation test. In cases in which the answer to the rationality query is conditionally affirmative, the Supreme Court has demonstrated a tendency to examine more closely such legislation to determine whether the connection between the known fact and the presumed fact is "not necessarily or universally true."[31]

If the exclusion of ex-offenders in *Miller* is considered rational, the irrebuttable presumption doctrine would next consider whether all ex-offenders are unfit to drive cabs. If the answer is no, then the presumption of unfitness would be found to violate due process.

This second inquiry allows courts to examine the legislation more closely than

28 Plaintiff had argued that the ordinance involved his fundamental right to work. 547 F.2d at 1320.

29 547 F.2d at 1319.

30 *See* Note, *Irrebuttable Presumption Doctrine in the Supreme Court,* 87 HARV. L. REV. 1534 (1974); Note, *Irrebuttable Presumptions: An Illusory Analysis,* 27 STAN. L. REV. 449 (1975).

31 Vlandis v. Kline, 412 U.S. 441, 442 (1973).

does the normal rational relation test. Because of this more rigid examination, the irrebuttable presumption doctrine has been labelled both as a revitalization of the strict scrutiny test of equal protection[32] and as a "safety valve to escape the rigidity of current equal protection doctrine."[33]

B. *Application of the Irrebuttable Presumption Standard in* Miller

Instead of manipulating its equal protection analysis, the Seventh Circuit could have used the irrebuttable presumption doctrine to examine closely the legislative scheme in *Miller*. Because of the the Supreme Court's recent decision in *Weinberger v. Salfi*,[34] however, the Seventh Circuit expressed doubt over the continued vitality of the irrebuttable presumption doctrine.[35]

An examination of *Salfi* and the leading irrebuttable presumption cases, however, leads to the conclusion that *Salfi* is not a radical departure from previous case law. Rather, it is better seen as a recognition of the common factors underlying the cases which have triggered the application of the doctrine. These common factors demonstrate that *Miller* is a proper case for the application of the doctrine.

In *Salfi*, the Supreme Court upheld the constitutionality of a provision in the Social Security program which denied benefits to widows unless their marriages were more than nine months old at the time of the wage earner's death. The aim of this provision was to prevent sham marriages whose sole purpose was to secure benefits for the widows. The plaintiffs in *Salfi* claimed that this provision denied them due process by creating an irrebuttable presumption.

The Court first held that a rational relation test would be applied to the presumption.[36] The Court expressed the fear, however, that the irrebuttable presumption doctrine, if extended, would amount to a "virtual engine of destruction for countless legislative judgments."[37] Such an extension would require individual determinations in a large number of legislative classifications. To obviate this problem, the Court added a "practicality standard." *Salfi* considered whether individual review could be effective and administratively feasible.

The inquiry in *Salfi*, then, focused on two points: 1) the familiar rational relation test and 2) the practical ability to make individual determinations.[38]

32 *Id.* at 460 (Burger, C.J., dissenting).

33 Note, *The Conclusive Presumption Doctrine: Equal Process or Due Protection?*, 72 MICH. L. REV. 800, 816 (1974).

34 422 U.S. 749 (1975).

35 547 F. 2d at 1318-19. Cf. Talbot v. Pyke, 533 F.2d 331 (6th Cir. 1976); Alcala v. Burns, 545 F. 2d 1101 (8th Cir. 1976); Fisher v. Secretary of U.S. Dept. of Health, Ed. & Welf., 522 F. 2d 493 (7th Cir. 1975), which follow *Salfi*. *See also* McInnis v. Weinberger, 530 F.2d 55 (1st Cir. 1976), expressing doubt over the vitality of irrebuttable presumptions after *Salfi*, and Thompson v. Weinberger, 548 F. 2d 1122 (4th Cir. 1976), distinguishing *Salfi* and applying a pure rationality test.

36 422 U.S. at 770.

37 422 U.S. at 772.

38 The question is whether Congress, its concern having been reasonably aroused by the possibility of an abuse which it legitimately desired to avoid, could rationally have concluded both that a particular limitation or qualification would protect against its occurrence, and that the expense and other difficulties of individual determinations justified the inherent imprecision of a prophylactic rule.
422 U.S. at 777.

Before a court can decide whether an irrebuttable presumption violates due process, it must ask whether individual determinations can be made with some degree of certainty and administrative economy.

On the surface, *Salfi*'s practicality test seems to restrict the close examination of legislation allowed under the "universally true" test of the irrebuttable presumption doctrine. Factors of practicality are, however, present in the leading irrebuttable presumption cases, as will be shown. *Salfi* merely articulates those factors. Viewed in this light, *Salfi* did not prevent the Seventh Circuit from applying the irrebuttable presumption doctrine in *Miller*.

The threshold question in this application in *Miller* would have been the issue of the rationality of the presumption and its relationship to the goals of public safety. The Seventh Circuit's handling of this issue has been previously discussed.[39]

Assuming, under the rationality query, that these relationships are not irrational or "wholly irrelevant to the achievement of the (city's) objective,"[40] the next inquiry under the irrebuttable presumption test would have been whether the presumption of unfitness is universally true. Although recidivism is a well-documented phenomenon, not all ex-offenders repeat their crimes.[41] Therefore, the presumption is not universally true.

The question of practicality is not as easily answered as the preceding ones. The evaluation of a person's character is not susceptible of an easy answer by any judicially or administratively efficacious formula. It must be remembered, however, that Chicago has already seen fit to provide for individual review for the ex-offender licensee. The city must feel that such determinations are feasible. Since determinations are made in these cases, they could also be made for the ex-offender applicant. *Salfi*'s practicality standard can, therefore, be satisfied in *Miller*. This interpretation of *Miller* and *Salfi* is consistent with the past history of the irrebuttable presumption. For example, the determinations in *Bell v. Burson*,[42] the first irrebuttable presumption case, were capable of relatively easy judicial resolution. In *Bell*, the Supreme Court struck down a Georgia statute which, pending the determination of liability, suspended the license of any uninsured motorist involved in an accident, unless such driver gave proof of his ability to satisfy any claimed damages. The implication of this procedure was that the uninsured motorist was at fault.

In invalidating the statute, the Supreme Court questioned the relationship between a driver's uninsured status, the suspension of his license because of the presumption of fault, and the goal of insuring payment to an injured party. Although the *Bell* Court did not explicitly discuss considerations of practicality, it is important to note that the determination of liability in an auto accident is one common to tort law. The issues involved in the presumption thus could properly be resolved in court. The invalidation of the presumption in *Bell* is

39 *See* text accompanying notes 19-23 *supra*.

40 McGowan v. Maryland, 366 U.S. 420, 425 (1961).

41 *Amici curiae* briefs in *Miller* indicated that 60% of people arrested are ex-offenders. Although this does not prove that the other 40% have been rehabilitated, it does lend support to the proposition that not all ex-offenders repeat their crimes. 547 F.2d at 1322.

42 402 U.S. 535 (1971). Although *Bell* did not use the language of irrebuttable presumptions, it was so interpreted by the Court in Vlandis v. Kline, 412 U.S. 441, 446-47 (1973).

consistent with *Salfi*. Furthermore, the fact that mechanisms existed to make the determinations in *Bell* supports the conclusion that the Seventh Circuit could have applied the irrebuttable presumption doctrine in *Miller*, where mechanisms exist to review the ex-offender licensees.

This disposition of *Miller* is consistent with the Supreme Court's conclusion in *Cleveland Board of Education v. Lafleur*.[43] *LaFleur* involved mandatory maternity leave for pregnant schoolteachers. The relationship between the Board's goal of providing continuity of instruction and physically fit teachers and the mandatory leave program was not found to be rational.[44] The presumption of unfitness in the fifth month of pregnancy was violative of due process. The physical fitness of a teacher was considered to be susceptible of efficient and conclusive medical determination on an individual basis.[45] As in *Miller*, the standards existed in *LaFleur* which made individual review practical.

Likewise, *Stanley v. Illinois*[46] supports the disposition of *Miller* on irrebuttable presumption grounds. In *Stanley*, the Supreme Court struck down a state statute which classified unwed fathers as unfit parents. Although the Court acknowledged that many unwed fathers may, indeed, be unfit to have custody of their children, such a relationship was not sufficient to pass the universally true test. These factors bear a relation to *Miller*. While many ex-felons may be unfit to drive a cab, this is not sufficient to justify the blanket exclusion of all ex-offenders. Further, the practicality standard is also satisfied in *Stanley*. As in *Bell*, determinations of child custody are within the ordinary purview of judicial activity.

The existence of administrative formulas to provide individualized review was also important in *Vlandis v. Kline*.[47] In *Vlandis*, the Supreme Court held that a state scheme for classifying students as residents and nonresidents for tuition purposes was an unconstitutional conclusive presumption. Married students whose applications came from other states and single students who had lived out of the state in the previous year were automatically classified as nonresidents. The Court held that due process required individual review. Justice Stewart's majority opinion noted that reasonable standards existed to determine residency.[48]

As in *Vlandis*, the existence of a viable mode of review for licensee felons is important in considering the constitutionality of the presumption in *Miller*. Individualized review in both cases seems practical.[49]

The preceding examination leads to the conclusion that, contrary to the feeling of the Seventh Circuit, *Salfi* did not preclude the application of the irrebuttable presumption doctrine to *Miller*. *Salfi* explicitly recognized the practicality factors which underlie previous cases. *Miller*, then, was a proper case for

43 414 U.S. 632 (1974), followed under similar facts in Turner v. Department of Employment Security, 423 U.S. 44 (1975).
44 414 U.S. 632, 648-49.
45 414 U.S. 632, 649-50.
46 405 U.S. 645 (1972).
47 412 U.S. 441 (1973).
48 *Id.* at 454.
49 Two other irrebuttable presumption cases, United States Dept. of Agriculture v. Moreno, 413 U.S. 528 (1973) and Jimenez v. Weinberger, 417 U.S. 628 (1974), only addressed the rationality issue.

the application of the irrebuttable presumption doctrine. Since the presumption contained in the ordinance is rational, but not universally true, *Salfi* called for the Seventh Circuit to determine whether individual review was practical. The practicality test is satisfied in *Miller* because of the existence of a mechanism to make individual determinations of the fitness of the ex-offender licensees. Consequently, the Seventh Circuit could have employed the irrebuttable presumption doctrine in *Miller* to invalidate the city's treatment of the ex-offender applicants.

IV. Conclusion

In deciding *Miller,* the Seventh Circuit departed from the policy of deferring to legislative judgments under the rational relation standard of equal protection. In finding that Chicago cannot deny licenses to ex-offender applicants while providing individual review for ex-offender licensees, it employed a more rigid standard of review than normally used under the rational relation test.

In doing so, the Seventh Circuit bypassed a due process analysis, which afforded a more suitable method to subject the ordinances to close examination. Instead of disregarding the irrebuttable presumption doctrine, the Seventh Circuit should have noted that *Salfi* articulated the factors of practicality underlying previous irrebuttable presumption cases. Such a clarification of the irrebuttable presumption doctrine in *Miller* would have obviated the necessity of distorting the rational relation test and contributed to the development of the irrebuttable presumption standard.

Thomas W. Millet

CONSTITUTIONAL LAW—FIRST AMENDMENT FREEDOM OF RELIGION—LABOR LAW—NLRB EXERCISE OF JURISDICTION OVER UNIT OF LAY TEACHERS IN PAROCHIAL SCHOOLS UNDER "COMPLETELY RELIGIOUS/MERELY RELIGIOUSLY ASSOCIATED" STANDARD CONSTITUTES ABUSE OF DISCRETION; CERTIFICATION OF UNIONS VIOLATES ESTABLISHMENT AND FREE EXERCISE CLAUSES OF FIRST AMENDMENT.

*Catholic Bishop of Chicago v. National Labor Relations Board**

I. Introduction

The first amendment[1] in its protection of religious freedom enunciates the two outer bounds between which government action must be contained. The Establishment Clause forbids legislation which would entrench a religious institution; the Free Exercise Clause prohibits governmental coercion of an individual religious practice. To stay within these bounds while attempting to further state educational goals by supporting parochial education has been described as "a matter upon which we can find no law but our own prepossessions."[2] In *Catholic Bishop of Chicago v. National Labor Relations Board,* the United States Court of Appeals for the Seventh Circuit faced yet another first amendment clash between religious and secular values, this time in the novel context of the National Labor Relations Act.[3]

The controversy[4] arose in June, 1974, when the Quigley Education Association[5] and the Community Alliance filed representation petitions with the National Labor Relations Board. The unions sought to represent two bargaining units, one composed of lay teachers employed at Quigley Seminary North and Quigley Seminary South,[6] the other of teachers employed by five high schools operated by the Diocese of Fort Wayne-South Bend in northeastern Indiana.

First amendment objections of excessive entanglement between church and state were raised by both employers during the representation hearings but were rejected by the Board on the strength of two similar cases decided by it in 1975 and 1976.[7] The Board stated in its hearing upon the Quigley petition that its policy was "to decline jurisdiction over [religiously sponsored organizations] only when they are completely religious, not just religiously associated."[8] The

* 559 F. 2d 1112 (7th Cir. 1977).

1 The amendment reads in pertinent part: "Congress shall make no law respecting an establishment of religion or prohibiting the free exercise thereof . . ." U.S. CONST. amend. I.

2 Illinois ex rel. McCollum v. Board of Education, 333 U.S. 203, 238 (1948) (Jackson, J., concurring).

3 29 U.S.C. §§ 151-1381 (1970).

4 The opinion disposes of two cases: No. 75-1600, involving the Catholic Bishop of Chicago, a corporation sale, and No. 76-1638, a petition for review by the Diocese of Fort Wayne-South Bend, Ind. The two cases reached the Seventh Circuit through slightly different procedures, which are not relevant to this comment.

5 An affiliate of the Illinois Educational Association, the intervenor in *Catholic Bishop.*

6 As the court noted at 1114 n.4, these schools do not train only religious but rather are preparatory institutions for boys who have some interest in the priesthood or are thought by their parish priest to have "potential for Christian leadership, either as a priest or as a layman."

7 Roman Catholic Archdiocese of Baltimore, 215 N.L.R.B. 249 (1975), and Cardinal Timothy Manning, Roman Catholic Archbishop of the Archdiocese of Los Angeles, 223 N.L.R.B. 1218 (1976).

8 Catholic Bishop of Chicago and Quigley Association, 220 N.L.R.B. 63 (1975).

Board concluded that the schools involved were merely religiously associated. It therefore ordered elections, which the unions won. The unions were then certified by the Board as the exclusive representatives of the lay faculties. In order to obtain judicial review of the certification, the employers refused to collectively bargain with the unions.

Upon the filing of unfair labor practice charges[9] the Board granted the unions' motions for summary judgment. The constitutional contentions raised by the schools were rejected on the grounds that:

> 1. The purpose of the National Labor Relations Act is to maintain and facilitate the free flow of commerce through the stabilization of labor relations;
> 2. The provisions of the Act do not interfere with religious beliefs;
> 3. Regulation of labor relations does not violate the First Amendment when it involves a minimal intrusion on religious conduct and is necessary to obtain that objective.[10]

The Board ordered the employers to bargain with the unions upon request and to post appropriate notices of labor laws applicable as a result of the certification. The church employers petitioned the Seventh Circuit to review and set aside the orders and the Board cross-applied for enforcement.[11]

The Seventh Circuit reversed the NLRB's adjudication of its jurisdictional reach on two grounds. First, the court found that the application to these schools of the "completely religious/merely religiously associated" standard was an abuse of the Board's discretion. This portion of the holding rests upon the court's conclusion that the standard constituted a *per se,* and therefore impermissible, inclusion of all parochial schools within NLRB jurisdiction. The court further justified this holding by suggesting that an institution which is too religious to receive government aid is too religious to tolerate government intervention in its labor relations.

The NLRB, however, also claimed that if it could not constitutionally draw the line of its jurisdiction according to the degree of the institution's religious permeation, it would be forced by the all-inclusive terms of the statute to exercise jurisdiction over all schools without regard to their religious nature. Therefore the court turned to the wider constitutional issue and held that the threshold act of certification of the unions necessarily altered and impinged upon the religious character of the schools. This prong of the decision relied upon the chill that the imposition of bargaining would impose upon the position of the bishop in canon law as the sole repository of church authority and upon his performance of the religious mission.

The court thus decided that a religious educational institution need not allow its professional employees to collectively bargain under the aegis of the National Labor Relations Act.[12] The case is unique; never before has the labor

9 The charges alleged violation of 29 U.S.C. §§ 158(a)(1) and (5), in the employer's refusal to bargain with certified bargaining representatives of employees.

10 Catholic Bishop of Chicago and Illinois Educational Association, 224 N.L.R.B. No. 164 (1976), and Diocese of Fort Wayne-South Bend and Community Alliance for Teachers of Catholic High Schools, 224 N.L.R.B. No. 165 (1976).

11 29 U.S.C. §§ 160(e) & (f)(1970).

12 29 U.S.C. §§ 151-1381 (1970).

bill of rights confronted the constitutional guarantee of religious freedom.[13] A survey of case law reveals a dearth of closely analogous precedent. All previous cases concerning religious education questioned the constitutional validity of governmental *assistance* to the institution and thus analyzed the problem under the Establishment Clause. *Catholic Bishop,* however, posed the problem of governmental *coercion* of the institution, in the form of NLRB regulation of labor relations. Although a Free Exercise analysis that focuses on impermissible coercion thus seems a more appropriate vehicle for this case, the Seventh Circuit attempted to adapt Establishment case law to the problem.

The adaptation, however, is an uneasy one and is further complicated by the court's conclusion that the decision rests upon both clauses. According to the court, it did not have to choose one clause upon which to base its decision because each "has the identical purpose of maintaining a separation between Church and State."[14] Whatever the validity of this equation, the court's statement reveals an attitude toward religious freedom cases which constitutes the most worrisome aspect of this decision. The Seventh Circuit may be reading correctly a shift in Supreme Court posture from what Justice Rehnquist has termed "benevolent neutrality"[15] to the original touchstone of first amendment law, the "high and impregnable wall" which separates church from state.[16]

Catholic Bishop at first glance seems to be a model of this benevolent neutrality. The decision upholds the view espoused by the religious institution that it must be free from government regulation of its employment relations. In that sense, *Catholic Bishop* is benevolent toward the institution. Certainly the exemption from government interference widens the institution's choices and thereby preserves its freedom. In order to justify the exemption, however, the court relied upon precedent which will brook no government proximity to religious activity. Thus, the neutrality which in this instance is benevolent to the institution is characterized by a rigidity which may equally bar such proximity when the government interest is in assisting rather than regulating the institution.

This comment will first examine the persuasiveness of the arguments marshalled by the Seventh Circuit. Each of these arguments demonstrates the overly cautious attitude of the court. Next the problem of NLRB jurisdiction over parochial schools will be analyzed via traditional Free Exercise Clause criteria, to illustrate that the *Catholic Bishop* court bypassed an appropriate vehicle for analysis of the case before it.

II. The NLRB's Jurisdictional Standard As an Abuse of Discretion

A. Per Se *Inclusion of Parochial Schools*

The first part of *Catholic Bishop* held that the Board's standard constituted

13 Caulfield v. Hirsch, 45 U.S.L.W. 2025 (D. Pa. July 7, 1977) is the only other case in the area. The court here awarded an injunction against a certification election on the basis of a Free Exercise analysis, following Wisconsin v. Yoder, 406 U.S. 25 (1972).

14 559 F.2d at 1131.

15 Walz v. Tax Commission, 397 U.S. 664, 810 (1971) (dissenting opinion).

16 Everson v. Board of Education, 330 U.S. 1, 18 (1974).

an abuse of discretion because it was equivalent to a *per se* inclusion of all parochial schools. The court discerned this equivalence by a three-step analysis. It first noted that the simple statement by the Board of the propriety of jurisdiction indicated that the Board had made no inquiry into the effect such jurisdiction would have upon the school. The court then commented that whenever a school is so religious as to preclude government assistance it is too religious to withstand government regulation. It supported its conclusion by characterizing a series of Supreme Court cases as the establishment of a positive "hands-off" attitude toward religion. An examination of each of these steps demonstrates the overly rigid posture assumed by the *Catholic Bishop* court.

The court began by conceding that the propriety of the Board's jurisdiction over nonprofit educational institutions as a class is well-established.[17] The court then noted that until 1974 the Board had refused jurisdiction over parochial schools in which the curriculum was exclusively concerned with religious subjects[18] and had only recently introduced the "completely religious/merely religiously associated" standard under scrutiny in the instant case.[19] Characterizing the "completely religious/merely religiously associated" standard as "a simplistic black or white, purported rule containing no borderline of where 'completely religious' takes over or, on the other hand, ceases,"[20] the court concluded that this rule would operate as a *per se* inclusion of all Roman Catholic secondary schools within NLRB jurisdiction. The court noted[21] that the Board explicitly approached the jurisdictional question on a case-by-case basis but concluded that the precedent cited by the Board to support its position[22] generated a rule which operated to include all "Catholic schools which offer the regular range of secondary subjects."[23]

Of special concern to the court was the Board's description of the institutions involved. The Board had stated that "the schools perform in part the secular function of educating children, and in part concern themselves with religious instruction. Therefore, we will not decline to assert jurisdiction over these schools on such a basis."[24] The Seventh Circuit reasoned that since all religiously sponsored secondary schools perform both religious instruction and secular education, all such schools would, by application of the Board rule, automatically fall within NLRB jurisdiction.

Arguably the Board intended to avoid this rigidity by its policy of *ad hoc* adjudication. The language quoted by the court illustrates this policy. The Board emphasized that because both secular and religious goals are pursued it would not decline jurisdiction *on that basis*. In other words, it was not enough

17 N.L.R.B. v. Wentworth Institute, 515 F.2d 550 (1st Cir. 1975).
18 Association of Hebrew Teachers of Metropolitan Detroit, 210 N.L.R.B. 1053 (1974), Board of Jewish Education of Greater Washington, D.C., 210 N.L.R.B. 1037 (1974), and Cardinal Timothy Manning, 223 N.L.R.B. 1218.
19 Roman Catholic Archbishop of Baltimore, 315 N.L.R.B. 249.
20 559 F.2d at 1118.
21 *Id.* at 1118 n.9.
22 Cardinal Timothy Manning, 223 N.L.R.B. 1218.
23 559 F.2d at 1118.
24 Cardinal Timothy Manning, 223 N.L.R.B. at 1218.

to point out that some religious affiliation complicated the issue.[25] Rather, the *extent* of that religious affiliation and its connection *in each case* with the employment relationship, with which the NLRB is exclusively concerned, would dictate whether jurisdiction was proper. The "completely religious/merely religiously associated" language thus described the legal conclusion to which the Board would come in each case, not the legal process to be employed.

In fact, the court was actually presented with evidence gathered by the Board to determine whether the schools in question were so religiously associated as to preclude its jurisdiction.[26] This probe by the Board seems as consistent with the *ad hoc* method the Board purported to follow as with a *per se* rule. The Board had commented previously that "[m]ost religiously associated institutions seek to operate in conformity with their religious tenets."[27] It is at least plausible that this was meant to warn that the Board would leave it to each case to decide whether that conformity forbids an assertion of jurisdiction.

The court attempted to buttress its rejection of the Board's jurisdictional standard by pointing out that the "completely religious/merely religiously associated" language collapses into one phrase the labels, such as "sectarian," "substantially religious," "prevasively sectarian," "church-affiliated," and "religion-pervasive," which the Supreme Court has used to describe varying amounts of religious affiliation.[28] The court suggested that such transmutation was an attempt to avoid deciding whether the effect of the Board's jurisdiction would be the establishment of, or interference with, religious beliefs or practices.

This inquiry into effect is, according to Supreme Court precedent, a necessary component of first amendment analysis. In *Lemon v. Kurtzman*[29] the Court considered the constitutionality of salary supplements for teachers of secular courses in sectarian schools and became the leading case in the Establishment area by laying down a tripartite test which the Supreme Court continues to apply. In order for a particular act to be permissible under the Establishment Clause, the law in question must be found to have a secular legislative purpose; neither advancement nor inhibition of religion may be its primary effect; and whatever church-state relation results must not be an excessive entanglement of one with the other.[30] Since a finding that such effect exists is sufficient to invalidate the law (or at least, as here, its contemplated application), the Seventh Circuit implied that the Board had shirked its duty.

The *Catholic Bishop* court, however, did not itself evaluate the effect of NLRB jurisdiction on the schools before it. Instead, the opinion turned to the specific language of previous Establishment Clause cases. Deciding that the schools before it were indistinguishable from those to which the Supreme Court

25 *See, e.g.*, Bishop Randall Hospital, 89 L.R.R.M. 1249 (1975) (hospital); Carroll Manor Nursing Home, 202 N.L.R.B. 1367 (1973) (old folks' home); and First Congregational Church of Los Angeles and Mortuary, Embalmers and Allied Funeral Services Employees Union, 189 N.L.R.B. 117 (1971) (cemetery).

26 The court detailed the line of questioning pursued by the hearing officer himself. His questions, dealing with the number and nature of liturgies and masses offered at the schools, would serve no other purpose than to aid in the making of a decision as to the extent of the religious affiliation of the institution. *See* 559 F.2d at 119 n. 11.

27 Roman Catholic Archdiocese of Baltimore, 216 N.L.R.B. at 250.

28 *See* 559 F.2d at 1119.

29 403 U.S. 602 (1971).

30 *Id.* at 612-13.

had previously denied government aid,[31] the court concluded that "[t]he fact that these institutions provide a secular as well as a religious education does not detract from the fact that 'the religious mission is the only reason for the schools' existence.' "[32] The centrality of the religious mission to the parochial schools' purpose has persuaded the Supreme Court that certain forms of government aid are constitutionally impermissible. This was taken by the Seventh Circuit to establish that government regulation of labor relations in such institutions was impermissible.

The court in this way attempted to prove that the Board misinterpreted precedent in the creation of its standard. It demonstrated instead that although the Board's decision was at least susceptible to an interpretation consistent with precedent, the analysis in *Catholic Bishop* was not. The responsibility of both the Board and the court was to discern whether the particular act contemplated by the government constituted an impermissible establishment or prohibition of religion. The degree of religious permeation of the school necessarily influences the answer to this question. As the Supreme Court stated in *Lemon*:

> In order to determine whether the governmental entanglement with religion is excessive, we must examine the character and purpose of the institutions that are benefitted, the nature of the aid that the State provides, and the resulting relationship between the government and the religious authority.[33]

By the very authority upon which the Seventh Circuit relied, a detailed investigation of the extent of the religious nature of the function which the governmental act touches is crucial.

"The function which the governmental act touches" is the focal point of this analysis. In *Lemon*,[34] the stated purpose of the teacher in the religious scheme of the school was decisive because the aid extended consisted of salary supplements. When the aid was for construction of secular college facilities, however, the investigation concerned itself with the role of buildings in the religious mission. The Supreme Court concluded that government regulation of buildings did not constitute excessive entanglement of church and state.[35]

These cases demonstrate that the first amendment inquiry must focus not upon the extent of the school's religious involvement as a whole, but rather upon the extent of the religious nature of the particular function affected by the governmental action. The NLRB's investigation in *Catholic Bishop* thus seems quite narrow and its conclusion is well articulated by the "completely religious/

31 Notably Lemon v. Kurtzman, 403 U.S. 602 (1971) and Meek v. Pittenger, 421 U.S. 349 (1975). In both these cases the parochial schools were secondary schools. The facts of *Lemon* are set out in the text accompanying notes 29 and 34. *Meek* denied Pennsylvania's proposal to loan instructional materials directly to the schools and to provide "auxiliary" services such as remedial instruction, counseling and testing. As will be discussed later, it is important to note that *Meek upheld* one portion of the aid package—the loan of textbooks to the students.

32 559 F.2d at 1122.

33 403 U.S. at 615.

34 *Id.*

35 Hunt v. McNair, 413 U.S. 739 (1973) and Tilton v. Richardson, 403 U.S. 672 (1971). It should be noted that another factor in *Tilton*, that the schools involved were colleges rather than elementary or secondary, also influenced the decision.

merely religiously associated" language rejected by the Seventh Circuit. Because the Board's duty is simply to police the employment relationship, the question is whether that relationship in a parochial school necessarily precludes governmental regulation.

The precedent upon which the Seventh Circuit relied[36] to give its affirmative response to this question seems inapposite to the narrowness of the question. *Meek v. Pittenger*[37] is best illustrative of the point. In *Meek,* plaintiffs attacked a statute awarding certain limited types of aid to private schools. The institutions involved were typical secondary parochial schools. Three types of aid were at issue: a direct loan of instructional materials to the institution; state provision of such auxiliary services as remedial instruction, counseling, and testing; and the loan of secular textbooks directly to students. Only the first two were struck down as unconstitutional.

The Seventh Circuit in *Catholic Bishop* relied upon the *Meek* Court's conclusion that "[i]t would simply ignore reality to attempt to separate secular educational functions from the predominantly religious role performed. . . ."[38] The court, however, ignored the fact that the attempt in *Catholic Bishop* should have been to separate secular *employment* functions from the predominantly religious role. As will be elaborated below, only those schools staffed by members of religious orders and run for the purpose of training religious functionaries *necessarily* involve such a non-severable relation. Such a school may be conveniently distinguished from other secondary schools by the label of "completely religious."

Although the Seventh Circuit criticized the Board for allegedly implementing a *per se* rule without precedent, the court's holding appears to be equally rigid. The court of appeals used the exclusion of salary grants to parochial schools in *Meek* to support its prohibition of NLRB policing of the employment relationship. Thus it effectively adopted a *per se* exclusion of all matters involving parochial schools and government regulation. By relying on the resemblance of the schools before it to those of *Meek* and *Lemon* to support the prohibition, it effectively excluded all parochial schools from NLRB jurisdiction. Just as a *per se* inclusion of all parochial schools would ignore the constitutionally mandated inquiry into effect, so too a *per se* exclusion fails to complete the investigation.

The holding of *Catholic Bishop* is thus subject to the same attack which the court lodged against the Board. This inflexibility is unfortunate because it ignores precedent. What is more troublesome is the manner in which it emphasizes the extraordinary effort the Seventh Circuit made to avoid the least proximity of government to religious activity. The court condemned what it viewed as a *per se* rule that would allow such proximity. In doing so, it propounded a *per se* rule of its own.

36 Meek v. Pittenger, 421 U.S. at 366, and Lemon v. Kurtzman, 403 U.S. at 616, 618-19, 634-35.
37 421 U.S. 349.
38 *Id.* at 365.

B. *The Whip-Saw Effect*

Perhaps the best indication of the court's underlying attitude is its description of what might be termed the "whipsaw" effect. The court contended that:

> The Board is cruelly whip-sawing their [parochial] schools by holding that institutions too religious to receive governmental assistance are not religious enough to be excluded from its regulation. . . . A church which chooses to educate its own young people in schools which it is required essentially to finance without government aid should because of the essentially religious permeation of its curriculum be equally freed of the obviously inhibiting effect and impact of the restrictions of the NLRA. . . .[39]

The Seventh Circuit here indicated its own *per se* rule—whenever a school is too religious to receive governmental assistance it is too religious for the NLRB to regulate its employment relations. This rule blurs the distinctions in types of aid permissible and in the necessary connection between the aid and the function affected by it. The court may simply have voiced here an understandable sympathy for the plight of underfunded parochial schools. It may have attempted to transform the Supreme Court's three-tiered analysis into an equation which simplifies the task. Whatever the motive, equating the standards for receiving aid with the standards for government regulation did precisely that which the court condemned: it effectively established a *per se* rule without a case-by-case inquiry into effect.

The importance of narrowing the question to the *particular* function has already been explored. The rigor of a *per se* rule would preclude any such narrow inquiry. Furthermore, the line which the Seventh Circuit drew here—no aid, no union—appears to ignore the fact that both *Tilton v. Richardson*[40] and *Meek* upheld certain types of parochial aid. In *Tilton,* where the proposed aid took the form of construction grants, the possibility that the school would present a sectarian subject with a religious bent was outweighed by the school's capability of restricting use of the physical facilities to secular purposes. The fact that on the college level the degree to which a course's subject matter is religiously colored is considerably less than that on the secondary level also influenced the result in *Tilton.*

The *Meek* decision adhered to the precedent established in *Board of Education v. Allen,* which allowed the state to loan textbooks to students of parochial schools. As the Supreme Court explained in *Allen,* "[W]e cannot agree with appellants either that all teaching in a sectarian school is religious or that the processes of secular and religious training are so intertwined that secular textbooks furnished to students by the public are in fact instrumental in the teaching of religion."[41] Thus, simply because the function involves teaching or secondary schools, governmental aid or interference is not necessarily precluded.

It can be seen from this analysis of the first portion of *Catholic Bishop* that although the approach utilized by the NLRB need not be viewed as a *per se* inclusion rule, the Seventh Circuit's exclusion from NLRB jurisdiction of all

39 559 F.2d at 1119, 1130.
40 403 U.S. 672 (1971).
41 392 U.S. 236, 248 (1968).

parochial schools of whatever religious permeation constitutes a *per se* exclusion. The court thereby revealed its underlying attitude: rigidity of reasoning which encourages government proximity to religious activity is banned; rigidity which forbids the proximity is lauded.

C. *The "Hierarchical Polity" Argument*

The Seventh Circuit's attitude toward the case before it was further clarified when it cited a series of Supreme Court cases which have established what the *Catholic Bishop* court called "the hierarchical polity doctrine." The Seventh Circuit cited these cases as mandating a positive "hands-off" posture with respect to "the decisions of the highest judicatories of a religious organization of hierarchical polity on matters of discipline, faith, internal organization, or ecclesiastical rule, custom or law.[42]

Although the doctrine established a limited principle of nonintervention, its use in this part of the opinion overstates the point. In the seminal case of the doctrine, *Gonzales v. Archbishop of Manila,*[43] the Supreme Court, through Justice Brandeis, refused to interfere with a church's denial of a chaplaincy claimed under the terms of a will which endowed it. His rationale, however, contained an important limitation which the Seventh Circuit failed to note. Justice Brandeis wrote:

> *In the absence of fraud, collusion, or arbitrariness* the decisions of the proper church tribunal on matters purely ecclesiastical, although affecting civil rights, are accepted in litigation before the secular courts as conclusive, *because the parties in interest made them so by contract* or otherwise. Under like circumstances, effect is given in the courts to the determinations of the judicatory bodies established by clubs and civil associations.[44]

This statement suggests that whenever fraud, collusion, or arbitrariness intrude, disputants may call upon the courts. Furthermore, the Court acknowledged that the rationale for the refusal to intervene is that the "parties in interest" made the decisions of the tribunal conclusive of the civil rights involved "by contract or otherwise." The extent of that consent and whether that consent has been overreached may well be within the courts' power to decide. A long line of cases has reiterated the exception, including the 1976 decision, *Kedroff v. St. Nicholas Cathedral,* which the Seventh Circuit cited for the "hands-off" policy.[45]

The opinion in *Catholic Bishop* gave some attention to the relation between teacher and bishop, apparently on the theory that this relation resembles that between church polity and its member clergy. In the words of the court:

> All of these essentially patricentric schools are completely subject to the authority of the respective bishops who have the general right of vigilance as to faith and morals and direct authority as regards religious instruction.

42 559 F.2d at 1120, citing *inter alia* Serbian Eastern Orthodox Diocese v. Milivojevich, 435 U.S. 696, 713 (1976).

43 280 U.S. 1 (1920).

44 *Id.* at 16-17 (emphasis added).

45 *See, e.g.,* Serbian Eastern Orthodox Diocese v. Milivojevich, 435 U.S. 696; Maryland and Virginia Churches v. Sharpsburg, 396 U.S. 367 (1970) (Brennan, J., concurring); Presbyterian Church v. Blue Hull, 393 U.S. 440 (1969); Kedroff v. St. Nicholas Cathedral, 363 U.S. 190 (1960); and Watson v. Jones, 80 U.S. 679 (1872).

> The bishops operate the schools through functionaries who are completely subservient to the bishops' authority.[46]

The court concluded that any governmental regulation of the employment relationship within parochial schools would constitute an impermissible intrusion upon the bishops' position as sole repository of authority.

This portion of the *Catholic Bishop* holding is troublesome not so much for its accuracy as for the attitude it magnifies. Ignoring the limitations on the doctrine that the Supreme Court has often repeated, the Seventh Circuit cited the cases as indicative of a judicial "hands-off" attitude. Again, the eagerness of the court to inflate the argument past its legitimate bounds indicates the fear with which the court regarded any government proximity to religious activity.

III. The Chill of Religious Freedom

Holding that the "completely religious/merely religiously associated" standard was an abuse of NLRB discretion would have disposed of the problem in *Catholic Bishop* were it not for the Board's alternate contention. In the face of such a decision, the Board said, it would be forced to exercise jurisdiction over all schools of whatever religious permeation. Therefore, the court addressed the wider constitutional issue and held that "[t]he real difficulty is found in the chilling aspect that the requirement of bargaining will impose on the exercise of the bishop's control of the religious mission of the schools."

A. *The Impact of "Chill" Analysis*

The court suggested that refusals to renew contracts because the instructor taught Masters and Johnson to biology students, or married a divorced Catholic, or was unwilling to structure a course in religion as directed by academic superiors,[47] illustrate the problem, since the NLRB would have to decide whether these were unfair labor practices for a religious employer. The court's language, however, emphasized that it was not these problems themselves which created the impermissible burden. Rather, the court regarded the caution in dealing with employees which the bishop would feel compelled to exercise, the certainty that he would "steer far wider of the unlawful zone,"[48] as an unconstitutional chill of first amendment freedom.

The fault in centering upon this chill as the injury lies not in flawed reasoning but in its emotional content. Certainly, finding a chill of first amendment rights is a respectable form of constitutional analysis. The problem here is that by doing so the court made the problems created by certification appear more burdensome than they really are. The concrete examples of possible entanglement posed by the court do not in themselves present insurmountable constitutional difficulty. Insubordination without more is quite clearly a sufficient reason for discharge. The Masters and Johnson dilemma is easily surmounted by prescribing (as do most elementary and secondary schools) a particular text and contractually agreeing with the teacher to limit the course to official materials.

46 559 F.2d at 1122.
47 Three charges such as these were filed with NLRB Region 25 in Indianapolis.
48 Speiser v. Randall, 357 U.S. 513, 526 (1958).

A discharge for unfitness could likewise be covered by a simple requirement in the school's charter or in individual contracts that the staff member remain a member in good standing of the religious community.

These solutions are by no means entirely satisfactory; however, they are reasonable solutions to these problems which do not seem unduly burdensome. Indeed, they might well benefit both parties by clarifying responsibilities. That such solutions exist indicates that the court viewed possible problems, without regard to their ease of solution, as an unconstitutional chill.

B. *Establishment v. Free Exercise Analysis*

One of the most puzzling aspects of the *Catholic Bishop* opinion is its reliance upon Establishment Clause analysis. Although the court never explicitly chose this route or rejected the Free Exercise Clause analysis, its reiteration of the fear of entanglement (an "establishment" term of art) and its almost exclusive reliance upon "establishment" cases show a decided preference for this mode of analysis. The choice seems inappropriate because these cases all deal with governmental aid to sectarian institutions. Perhaps in anticipation of this distinction, the court commented that "[t]here are substantial aspects in the present cases in our opinion not only of sovereign involvement in the religious activity under the Establishment Clause but there is undoubtedly in our view also curtailment of the free exercise of religion under the second prong of the Religion Clauses."[49] The emphasis of this language, however, demonstrates that the court considered the primary inquiry to be focused upon the alleged violation of the Establishment Clause. Both the exclusive focus upon state establishment and the concluding statement that "each of [the clauses] has the identical purpose of maintaining a separation between Church and State"[50] seem an overstatement of Supreme Court interpretation of the first amendment. *Engel v. Vitale*,[51] while invalidating a state requirement of daily prayer in public schools, enunciated the distinction between the two clauses.

> Although these two clauses may in certain instances overlap, they forbid two quite different kinds of governmental encroachment upon religious freedom. The Establishment Clause, unlike the Free Exercise Clause, does not depend upon any showing of direct governmental compulsion and is violated by enactment of laws which establish an official religion . . .[52]

Abington School District v. Schempp,[53] which held unconstitutional the practice of reading Bible verse in public schools, also emphasized the difference by making clear that proof of a Free Exercise claim requires proof of actual coercion, while an Establishment claim does not.[54] In *Walz*, the Court similarly warned that "[t]o equate the two [clauses] would be to deny a national heritage with roots in the Revolution itself."[55]

49 559 F.2d at 1131.
50 *Id.*
51 370 U.S. 421 (1962).
52 *Id.* at 430.
53 374 U.S. 203 (1963).
54 *Id.* at 223.
55 397 U.S. at 673.

Distinguishing between a Free Exercise claim and an Establishment claim and applying the proper test is thus crucial. In one of the cases in which the Supreme Court sustained the state Sunday closing laws against first amendment claims, it delineated the contours of the Free Exercise inquiry:

> To strike down, without the most critical scrutiny, legislation which imposes only an *indirect burden* on the exercise of religion, i.e., legislation which does not make unlawful the religious practice itself, would radically restrict the operating latitude of the legislature . . . But if the state regulates conduct by enacting a general law within its power, the purpose and effect of which is to advance the State's secular goals, the statute is valid despite its indirect burden on religious observance unless the state may accomplish its purpose by means which do not impose such a burden.[56]

An Establishment Clause inquiry, on the other hand, provides a different emphasis. The three-prong test of *Lemon* remains essentially intact today.[57] "First, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion . . . ; finally, the statute must not foster 'an excessive governmental entanglement with religion.' "[58]

The difference in the two approaches is subtle. When the question of free exercise is raised, once the secular purpose and effect of the law are established and the regulation is shown to be something less than the outright prohibition of a religious practice itself, the statute will stand unless another less burdensome method is available to accomplish the legitimate secular end which the state wishes to advance. The difference between the two lines of analysis, then, appears primarily in the third test. In Establishment Clause doctrine, the question is whether the law fosters excessive entanglement with religion; in Free Exercise Clause examination the law must be the least burdensome means available. The choice of analysis may thus be determinative of a law's constitutionality. If a law is seen as entangling church and state, yet no other method will advance the state purpose, one line of argument would uphold it and the other would strike it down.

The choice of Establishment Clause analysis by the *Catholic Bishop* court is therefore particularly puzzling. Since state regulation rather than state assistance appears to involve essentially free exercise obstacles, the use of the Establishment Clause serves to reinforce the notion that the Seventh Circuit was extremely reluctant to tolerate any proximity of government interest to religious activity.

IV. Application of Free Exercise Analysis to *Catholic Bishop*

Having explored the importance of correctly identifying the religious clause in question, it would be useful to discern the result of a Free Exercise analysis of *Catholic Bishop*. Based on the case law studied above, the analysis would take

56 Braunfeld v. Brown, 366 U.S. 599, 606-07 (1961). It should be noted that a persuasive factor in the *Sunday Closing Cases* was the Court's conclusion that the laws constituted a mere indirect burden on religious freedom. This "factor" seems to be more of a description of the legal conclusion which the Court reached than a part of its tools for analysis.

57 *See* Roemer v. Maryland Public Works Board, 426 U.S. 736, 748 (1976).

58 403 U.S. at 612-13.

three parts. First, the purpose of the legislation must be found to be an important one of secular emphasis. Second, the effect of the law must also be secular. Finally, the legislation must be the least burdensome means available to further the secular end.

A. *Step One: The Secular Purpose and Legitimate Government Interest*

The test would begin by identifying the purpose of the National Labor Relations Act. In the words of its preface, the legislation is "[a]n Act to diminish the causes of labor disputes burdening or obstructing interstate and foreign commerce. . . ."[59] In the first section of the Act the drafters emphasized two separate aspects of this purpose: encouragement of friendly settlement of labor disputes and an equalization of bargaining power between the parties involved.[60] This purpose is sought through "protection by law of the right of employees to organize and bargain collectively" because "experience has proven that [such] protection . . . safeguards commerce from injury, impairment or interruption, and promotes the free flow of commerce. . . ."[61]

In the exercise of its commerce power, a power which is plenary once its objects are properly chosen,[62] Congress has thus sought to prevent the problem of large-scale disturbances of commerce resulting from labor unrest by providing a neutral adjudicatory process and encouraging nonviolent resolution of disputes. The large number of parochial schools in the United States illustrates a legitimate connection between public order and the possibility of teacher strikes which the NLRB sought to avoid in *Catholic Bishop*.

Perhaps the best method of weighing the governmental interest here is to consider those who will be the most harmed by the court's abstention—children. The Supreme Court has repeatedly stated that where young people's protection is threatened, more governmental intrusion and even coercion or prohibition will be tolerated.[63] That this added interest may be determinative of the Free Exercise claim is demonstrated by comparing *Cantwell v. Connecticut*[64] with *Prince v. Massachusetts*.[65] Both cases concerned the extent of one's right to proselytize on the public streets. In most respects the inhibition contained in the law in *Cantwell* seemed more restrictive than that of *Prince*. The former merely required a colporteur to obtain a license while the latter prohibited all minors from solicitation. Yet *Cantwell* held the practice unconstitutional, and *Prince*'s stood. The difference appears to be that "the power of the State to control the conduct of children reaches beyond the scope of its authority over adults, as is true in the case of other freedoms. . . ."[66] The principle was upheld in the last term of the Court. In considering yet another parochial aid case, the Court commented:

59 29 U.S.C. § 150 (1970).
60 29 U.S.C. § 151 (1970).
61 *Id.*
62 *See, e.g.*, Gibbons v. Ogden, 22 U.S. 1, 196-97 (1824).
63 *See, e.g.*, Abington School District v. Schempp, 374 U.S. 203 (1963).
64 310 U.S. 296 (1939).
65 321 U.S. 158 (1944).
66 *Id.* at 170.

> There is no question that the State has a substantial and legitimate interest in insuring that its youth receive an adequate secular education. The State may require that schools that are utilized to fulfill the state's compulsory education requirement meet certain standards of instruction, and may examine both teachers and pupils to ensure that the State's legitimate interest is being fulfilled.[67]

The importance of this governmental interest in preventing labor unrest in parochial schools and thereby insuring an uninterrupted and high quality secular education seems at least as strong as "the government's interest in procuring the manpower necessary for military purposes,"[68] the interest in protecting labor unions from being used as tools for Communist takeover,[69] or the public interest in providing a universal day of rest,[70] all of which have been upheld as legitimate justifications for governmental intrusion upon first amendment rights. Thus the NLRA and its application in *Catholic Bishop* may be viewed as having a secular purpose.

B. *Step Two: The Secular Effect of the Law*

Having established that the governmental interest is an important one of secular emphasis, a court must apply the second part of the Free Exercise analysis. The law must be found to be secular in effect.

Part of the Seventh Circuit's analysis of whether the government involvement constitute "excessive entanglement" is applicable here, for the two tests are similar.[71] Still, the result reached by the court within the Establishment mold may somehow be influenced by that context. J. Morris Clark in his discussion of the secular effect test of the Free Exercise Clause has suggested that "the importance of a law should be measured . . . by the incremental benefit of applying it to those with religious scruples."[72] Because this yardstick is uniquely tailored to the balancing demanded by Free Exercise analysis, it will be used here as the measure of the NLRA's secular effect.

The *Catholic Bishop* court itself provided the answer to the inquiry into effect as narrowed by Clark's suggestion. The court acknowledged that private education today figures significantly in the improvement of national knowledge, competence, and experience.[73] This role seems quite important when viewed in the light of government interest in education in general and could thus warrant the intrusion of NLRB jurisdiction. The Seventh Circuit, however, rejected any "economic impact" argument that would justify the application of NLRB jurisdiction because the abolition of the parochial school systems would impose a heavy economic burden upon taxpayers. He noted that such an argument had never persuaded the Supreme Court[74] and that, if anything, "increasing state

67 Wolman v. Walters, 45 U.S.I.W. 4861, 4864 (U.S., June 24, 1977) (citations omitted).
68 Gillette v. United States, 401 U.S. 437 (1971).
69 American Communications Association v. Douds, 339 U.S. 382 (1950).
70 The Sunday Closing Cases, 366 U.S. 420 (1961).
71 Justice White has emphasized this similarity in his call for the abolition of the entanglement test. *See* Roemer v. Maryland Public Works Board, 426 U.S. at 748.
72 Clark, *Guidelines for the Free Exercise Clause,* 83 HARV. L. REV. 327 (1969).
73 559 F.2d at 1131.
74 *Id.*

aid could lead to divisiveness related to religious beliefs and practice and the need for continuing and increasing annual appropriations."[75]

As noted above, the possibility of creating political divisions along religious lines was one of the problems the Court sought to avoid in *Lemon* by use of the excessive entanglement prong of Establishment Clause analysis. No increase in state aid was at issue in *Catholic Bishop*; no need to continue and increase annual appropriations could ever arise from the extension of NLRB jurisdiction. If these private schools provide a "significant and valuable role" in national education, the prevention of their disruption by easing labor unrest may very well constitute a sufficient "incremental benefit" to provide the test with a secular effect. In short, avoiding the economic impact which would result from a massive labor shutdown of parochial schools constitutes the legitimate secular effect of extending NLRB jurisdiction to the institutions involved in *Catholic Bishop*. Whatever detrimental effect upon the schools emerged from the Seventh Circuit's examination of possible "chill" must be weighed against this countervailing secular effect. Clark's method of determining the importance of a law by measuring the incremental benefit indicates the secular effect of the contemplated application—the significant benefit to education of peace in sectarian schools. No attempt to measure this benefit appears in the Seventh Circuit's opinion in *Catholic Bishop*.

C. *Step Three: Less Burdensome Means Available?*

The remaining question, then, is whether the state may accomplish this purpose by less burdensome means. A comparison of today's relative domestic calm with the labor wars of pre-NLRA days answers the question. During those troubled years no amount of legislation or judicial intervention cured the problem. Indeed the stopgap measures which were utilized resulted in still more labor unrest. Those days of experimentation yielded not one alternative which proved workable. The use of an administrative agency to encourage collective bargaining appears to be not only the least burdensome but indeed the only means of accomplishing the state purpose of finding peaceful solutions to labor disputes.

Thus, the exercise of jurisdiction by the NLRB over the Quigley and Fort Wayne-South Bend schools can be justified by use of a Free Exercise test, yet is unconstitutional by the Seventh Circuit's Establishment Clause analysis. Of course, the result obtained through the Free Exercise analysis outlined above is not the only possible conclusion of such an inquiry. A court utilizing the Free Exercise test could well have concluded that the Board's action was impermissible. This exposition is intended only to demonstrate that the vigor of the Seventh Circuit's reversal upon Establishment Clause grounds failed to acknowledge the possibility of reaching a different conclusion, or even of undertaking a Free Exercise examination. The court's eagerness to avoid any government proximity to religious activity is apparent from this omission.

The treatment in *Catholic Bishop* of a recent E.E.O.C. regulation, 29 C.F.R. § 1605.1 (1974), suggests how the Seventh Circuit would have solved

75 *Id.*

this conflicting interpretation had it directly confronted the problem. The regulation interprets the duty not to discriminate on religious grounds imposed upon employers by Title VII of the Civil Rights Act of 1974 as including an obligation to make reasonable accommodations to the religious needs of employees where such accommodations could be made without undue hardship to the employer's business. In discussing the Board's suggestion during oral argument that the special needs of these school employers which stem from their religious affiliation could be similarly "accommodated,"[76] the court commented, "[w]e fail to comprehend the real possibility of accommodation in the present context without someone's constitutional rights being violated, which in turn would seem to preclude the possibility of accommodation as an answer to the obviation of the religious entanglement problem."[77] From this comment emerges the court's preference for a legislative structure which is as far removed from government proximity to religious activity as judicial decree can devise.

V. The Clauses in Conflict

This overcautious attitude of the Seventh Circuit is exemplified by another omission from the Seventh Circuit's decision in *Catholic Bishop.* Assuming that the court's analysis of the Establishment Clause violation is persuasive, *Walz v. Tax Commission,*[78] a landmark case in first amendment analysis, suggests that the inquiry is not yet complete. The constitutionality of *forbidding* the proposed application must also be examined.

In *Walz* the Court came to the conclusion that both upholding and invalidating the law would be unconstitutional. Allowing a tax exemption to churches appeared to be an establishment of religion; removing it entangled the state with the church and bordered on coercion. The Supreme Court opted for the apparent establishment of religion and allowed the exemption.

Just as in *Walz,* there is some danger in *Catholic Bishop* that invalidating the application may itself create an impermissible burden on the free exercise of religion. This analysis focuses upon the interests of the parochial school teachers. Denying NLRB jurisdiction to parochial school teachers can be viewed as conditioning a public benefit—the right of an employee to be protected through collective bargaining—upon the relinquishing of a religious practice—teaching within one's own religious atmosphere.[79]

Sherbert v. Verner[80] enunciated the Supreme Court's view of such pressure. In *Sherbert* the Court held unconstitutional on Free Exercise grounds the withholding of unemployment compensation to those who refuse on religious grounds to work on Saturday. According to the Court, "conditions upon public benefits cannot be sustained if they so operate, whatever their purpose, as to inhibit or

76 559 F.2d at 1128-29.
77 *Id.* at 1130.
78 397 U.S. 203.
79 Of course, some of the teachers in parochial schools may not even be Catholic, and many of them may teach in these schools for reasons other than the nurture of their religious beliefs. To the extent, however, that one accepts the Seventh Circuit's insistence that the schools exist *only* for the purpose of "carry[ing] out the teaching mission of the Catholic Church" (559 F.2d at 1122), the likelihood of one of those teachers cherishing his or her role in that mission as a mandate of his or her faith increases accordingly.
80 374 U.S. 398 (1963).

deter the exercise of first amendment freedoms."[81]

Invalidation of the exercise of NLRB jurisdiction may thus pit the clauses one against the other, just as in *Walz*. Extending the jurisdiction is an invitation to excessive entanglement which would chill the religious organization's performance of the religious mission; denying it conditions impermissibly a public right. The *Walz* court reasoned that an establishment of religion was less burdensome than coercion and allowed the exemption. By refusing the application, *Catholic Bishop* implied, if only by omission, that the establishment which would result from the special machinery necessary to effect NLRB jurisdiction is more burdensome than the coercion that would result from this conditioning of rights under the NLRA upon the relinquishing of a religious practice. The Seventh Circuit again evinced a desire to avoid all government proximity to religious activity.

VI. Conclusion

The choice before the Seventh Circuit in *Catholic Bishop* illustrates the "blurred, indistinct, and variable"[82] nature of the first amendment guarantee of religious freedom. Perhaps Justice Jackson's admission that our prepossessions are the only guide we possess is the real answer. Certainly one can sympathize with the fear of the Seventh Circuit. Our history demands that any governmental action which touches our religious freedom be viewed with suspicion. If the worst fears of some observers materialize, unionization of the parochial schools will bankrupt the system, forcing the churches to forego an integral part of their mission. This would impose a heavy economic burden on the states, and would destroy a valuable method for instilling morality through education.

Despite this attitude of concern, the "benevolent neutrality" of *Catholic Bishop* is far more neutral than it is benevolent. Repeatedly the emphasis is upon a removal of government from *all* proximity to religious activity, an emphasis which only serves to make difficult the devising of any plan to aid the schools which *Catholic Bishop* protects.

Thus, the potential impact of *Catholic Bishop* on all future parochial aid and governmental regulation cases is troublesome. The rigidity of the "no aid, no union" wall upon which the court depends may well be an accurate reading of the tone of recent Supreme Court decisions. As the Seventh Circuit noted, cases from the Court this term have referred to the firm roots of Religion Clause precedent, irrespective of whatever bends and turns the wall of separation now contains.[83] The flexibility of the barrier may now be vanishing, and with it could go much of the previous benevolent neutrality and compassionate attention to the religious life of the ordinary citizen. The possibility of devising a plan for state aid to parochial schools which will pass scrutiny becomes smaller in direct proportion to the rigidity of this church/state separation. Ironically, the view adopted by the court could very well destroy the institution it seeks to save.

Paula Jean Fulks

81 *Id.* at 405.
82 Lemon v. Kurtzman, 403 U.S. at 614.
83 559 F.2d at 1119.

CONSTITUTIONAL LAW—ATTORNEYS—PRIVILEGE AGAINST SELF-INCRIMINATION—FIFTH AMENDMENT DOES NOT PROTECT AGAINST USE OF COMPELLED TESTIMONY IN BAR DISCIPLINARY PROCEEDINGS; FEDERAL PROSECUTOR MAY NOT EXTEND IMMUNITY GRANT TO USE OF COMPELLED TESTIMONY IN BAR DISCIPLINARY PROCEEDINGS.

*In Re Daley**

The privilege against self-incrimination embodied in the fifth amendment of the United States Constitution[1] is one of the individual's fundamental protections against the power of the government. Yet the privilege runs counter to the clear interest of the government in securing the testimony of its citizens for the public good. In an attempt to resolve this conflict, Congress has enacted immunity statutes which purport to afford a witness compelled to testify the protections against self-incrimination guaranteed by the fifth amendment.

In 1892 the Supreme Court ruled that for an immunity statute to be constitutional, it must provide protections "coextensive" with that afforded by the fifth amendment.[2] Exactly what the Court meant by "coextensive" has been the subject of a long history of litigation since 1893. Some questions, such as whether transactional or use immunity is required, have been answered conclusively by the Court.[3] Yet the extent to which the fifth amendment protects against the use of testimony in proceedings other than traditional criminal prosecutions but which nevertheless have punitive effects on the witness remains an open question. In *In Re Daley,* the Seventh Circuit addressed the question of whether the compelled testimony of a witness could be used against him in a state bar disciplinary proceeding. The court held that such protection is beyond the scope of the self-incrimination clause of the fifth amendment. The court concluded that bar disciplinary actions are not criminal in nature and that the constitutional prohibition against use of compelled testimony does not apply to them. Therefore, the court asserted that a grant of immunity purporting to supplant the fifth amendment privilege also does not provide such protection.

I. The Facts

In May, 1974, John Daley, an Illinois attorney, was subpoenaed to testify before a federal grand jury in Chicago. After consulting with his attorney, Daley informed the United States Attorney that he intended to assert his fifth amendment privilege against self-incrimination. The U.S. Attorney then applied to the United States District Court for the Northern District of Illinois for an immunity order pursuant to 18 U.S.C. §§ 6001-03.[4] The application purported to immunize Daley against use of his compelled testimony in any criminal prosecu-

* 549 F.2d 469 (7th Cir. 1977).

1 "No person . . . shall be compelled in any criminal case to be a witness against himself. . . ." U.S. CONST. amend. V.

2 Counselman v. Hitchcock, 142 U.S. 547, 585 (1892).

3 Kastigar v. United States, 406 U.S. 441 (1972).

4 18 U.S.C. §§ 6001-03 are the general federal immunity statutes applicable to court and grand jury proceedings.

tion, and, in order to insure the integrity of the testimony, against its use in any subsequent bar disciplinary proceedings. On July 18, 1974, Chief Judge Robson issued the immunity order.

Daley testified before the grand jury and at the subsequent extortion trial of Cook County Commissioner Charles Bonk. He related that he had bribed and paid Bonk thousands of dollars to obtain zoning variances favorable to his developer-clients.

On the basis of this testimony, the Illinois Attorney Registration and Disciplinary Commission[5] instituted proceedings to determine whether Daley should be disciplined for his activities. The Commission refused to honor the immunity order of Judge Robson.

In response, Daley filed a motion in the Northern Illinois district court for an order to compel the Commission to honor the immunity order of July 18. Chief Judge Parsons granted the motion and issued an order restraining the Commission from use or derivative use of Daley's testimony, and the Commission appealed the order to the Seventh Circuit.

II. The *Daley* Court's Focus

The crucial question in *Daley* was whether a state bar disciplinary action is a criminal proceeding within the scope of the fifth amendment.[6] The court answered the question by focusing on the purpose of bar disciplinary proceedings. The Seventh Circuit stated that disciplinary proceedings are not intended to impose criminal sanctions, but rather to make a "determination of the moral fitness of an attorney to practice law."[7] The court held that because the " 'sole concern [of the self-incrimination clause] is, as its name indicates, with the danger to a witness forced to give testimony leading to the infliction of penalties affixed to criminal acts . . . ,' "[8] the fifth amendment does not protect a witness from adverse findings in bar disciplinary proceedings. The court held that the privilege protects only against sanctions that result from conduct "adjudged violative of the criminal law."[9] By focusing on the avowed purposes of bar disciplinary proceedings, the *Daley* court ignored the punitive effect of the proceedings and made a questionable policy decision with regard to the scope of the fifth amendment privilege against self-incrimination.

III. The Erosion of the Fifth Amendment Privilege

The *Daley* court limited the substantive scope of the self-incrimination clause, and in doing so followed a general trend developed by the courts and

5 Hereinafter cited as the Commission.

6 The privilege against self-incrimination may be asserted in any proceeding, including criminal trials, civil proceedings, grand jury investigations, administrative proceedings, and legislative investigations. Kastigar v. United States, 406 U.S. 441, 444 (1972). The crucial issue in determining one's right to assert the privilege is not the "label" attached to the particular proceeding involved, but rather whether the proceeding has the potential for imposing criminal-like sanctions.

7 549 F.2d at 474.

8 *Id.* at 474 (quoting Ullmann v. United States, 350 U.S. 422, 438-39 (1956)).

9 549 F.2d at 474.

Congress. To understand the case, it is therefore necessary to review briefly the history of the self-incrimination clause in relation to immunity statutes.

There has been a slow but steady erosion of the scope of the privilege against self-incrimination, but always in the face of stiff opposition. The erosion of the privilege has occurred chiefly through the promulgation of immunity statutes designed to compel an individual to surrender his right to silence in exchange for guarantees that his testimony will not be used against him by the government.

The first Supreme Court test of an immunity statute came in *Counselman v. Hitchcock.*[10] Counselman, a grain shipper, had refused to testify concerning the acceptance of rate rebates in violation of the Interstate Commerce Act, despite the extension of immunity pursuant to the Immunity Act of 1868.[11] The Court struck down the 1868 statute as unconstitutional but did not declare immunity statutes unconstitutional *per se.* Rather, the *Counselman* Court indicated that an immunity statute could be considered constitutional only if it provided protection "coextensive" with that afforded by the fifth amendment. The Court stated that to satisfy this requirement, a statute must "afford absolute immunity against future prosecution for the offense to which the question relates."[12] Because the 1868 statute did not provide such absolute immunity, it was held unconstitutional.

In response to the *Counselman* decision, Congress in 1893 enacted an amendment to the Interstate Commerce Act that provided immunity to witnesses compelled to testify regarding matters in interstate commerce.[13] The amendment provided that in exchange for compelled testimony ". . . no person shall be prosecuted or subjected to any penalty or forfeiture for or on account of any transaction, matter or thing, concerning which he may testify. . . ."[14]

In *Brown v. Walker,*[15] the Supreme Court found the 1893 Act constitutional and upheld the principle of immunity statutes. The *Brown* Court stated, "While the constitutional provision in question is justly regarded as one of the most valuable prerogatives of the citizen, its object is fully accomplished by the statutory immunity. . . ."[16] Four justices disagreed, however, and registered powerful dissents. Justice Field asserted that the fifth amendment was intended to protect against public disgrace in addition to criminal prosecution. He argued that because the statute in question did not provide such protection it was not coextensive with the fifth amendment, as required by *Counselman.*[17] Justice Shiras, joined by Justices Gray and White, also dissented. They argued that there is a presumption against construing any act of Congress to supplant a constitutional privilege and that Congress does not have the power to divest or impair such a privilege.[18] Nevertheless, the 5-4 decision in *Brown* was not challenged in the Court until 1956, and the 1893 statute became a model for subsequent federal immunity legislation.

10 142 U.S. 547 (1892).
11 Act of Feb. 25, 1868, ch. 8, 15 Stat. 37, later Rev. Stat. 860 (1875).
12 142 U.S. at 586.
13 Act of Feb. 11, 1893, ch. 83, 27 Stat. 443.
14 *Id.*
15 161 U.S. 591 (1896).
16 *Id.* at 610.
17 *Id.* at 631.
18 *Id.* at 621.

In 1956, the Supreme Court reaffirmed the immunity principle in *Ullman v. United States.*[19] The case came to the Court on a writ of certiorari from the Court of Appeals for the Second Circuit, where several judges had expressed concern for the erosion of the privilege against self-incrimination through the use of immunity statutes.[20] Justice Frankfurter, however, reaffirmed the holding in *Brown* and noted that immunity grants had become "part of our constitutional fabric."[21] Justice Frankfurter stated that the 1893 statute "has been included 'in substantially the same terms, in virtually all of the major regulatory enactments of the Federal Government.' "[22] Justice Douglas, with whom Justice Black concurred, indicated that he would have overruled *Brown* on the ground that the fifth amendment was intended to provide a right to silence that no statute could abrogate. Justice Douglas also argued that the fifth amendment protected against non-law inflicted penalties.[23]

A further erosion of the privilege against self-incrimination through the medium of immunity statutes resulted from acceptance of the idea that a statute need only protect against use and derivative use of compelled testimony rather than provide absolute or transactional immunity against prosecution for the offense.[24] This concept was first suggested by the Supreme Court in *Murphy v. Waterfront Commission*[25] and later adopted in *Kastigar v. United States.*[26] The *Kastigar* Court held that the broad absolute immunity requirement set forth in *Counselman* had been unnecessary to the Court's decision and was therefore not binding authority. It reached this conclusion despite the fact that absolute immunity was considered by Congress as the test of constitutionality in enacting the 1893 statute, and was so treated by the courts in subsequent tests of immunity statutes.

It should be noted at this point that despite the general trend of limiting the scope of the privilege against self-incrimination through the use of immunity statutes, a degree of expansion of the protection afforded by immunity statutes has occurred with regard to the authorities bound by an immunity grant. In *Ullman,* the Supreme Court held that a federal immunity statute bound the states through the supremacy clause of the Constitution.[27] Then in *Malloy v. Hogan*[28] the Supreme Court held that the same standards applicable to determining the validity of an assertion of the privilege applied to the states in full

19 350 U.S. 422 (1956).
20 United States v. Ullmann, 221 F.2d 760 (2d Cir. 1950). *See* the concurring opinions of Judges Clark and Galston.
21 350 U.S. at 438.
22 *Id.* at 438 (quoting Shapiro v. United States, 335 U.S. 1, 6 (1947)).
23 350 U.S. at 440 (Douglas, J., dissenting).
24 Use and derivative use immunity provides a quantitatively different degree of protection for the witness than absolute or transactional immunity. Transactional immunity provides that once a witness has testified he cannot be prosecuted for any transaction, matter, or thing revealed in his testimony. Use and derivative use immunity provides only that the testimony itself cannot be used in a subsequent prosecution or to aid in investigations into criminal activity. Use and derivative use immunity does not provide an absolute bar to prosecution for matters revealed in the testimony. The witness may be prosecuted later for the offense if the investigation and prosecution are not tainted by use of the compelled testimony.
25 378 U.S. 52 (1964).
26 406 U.S. 441 (1972).
27 350 U.S. at 436.
28 378 U.S. 1 (1964).

force through the fourteenth amendment.[29] Finally, in *Murphy* the Supreme Court held that the fifth amendment not only protects federal witnesses against incrimination under both federal and state law, but that it also protects state witnesses against incrimination under both state and federal law. The *Murphy* Court held that because a grant of immunity under a statute supplants the fifth amendment privilege, a federal immunity grant must be honored by the states and a state immunity grant must be honored by federal authorities.[30]

It has also held that the privilege may be asserted in any proceeding.[31] The privilege does not, however, protect against any sanction imposed by a civil, administrative, or legislative proceeding. The sanction must be of a criminal character. The testimony must be "incriminating."

On balance, the extent of the scope of protection afforded under the fifth amendment privilege against self-incrimination has suffered. Despite narrow decisions in the early tests of the constitutionality of immunity statutes, their use has become, as Justice Frankfurter stated, "part of our constitutional fabric." It is interesting to note that the privilege against self-incrimination has been expanded by applying it to the states through the fourteenth amendment and by allowing it to be asserted in any proceeding as long as the testimony is deemed incriminating. On the other hand, the substantive scope of the privilege has been narrowed over the years. The privilege of silence, the original concept of the privilege against self-incrimination, can now be abrogated by a grant of immunity coupled with an order to testify. The right to remain silent is a broader concept than a right to immunity if compelled to testify. A witness would undoubtedly prefer to remain silent rather than disclose his illegal activities and suffer public opprobrium and other non-official sanctions. In addition, by contemporary standards the immunity granted need not provide absolute immunity, but instead must protect only against use and derivative use of the compelled testimony in any subsequent criminal investigation or proceeding against the witness.

IV. *Daley* in Perspective

It is necessary to examine *Daley*'s position in the historical development outlined above. The Seventh Circuit's holding in the case is a further step in the general trend of narrow interpretations of the scope of the self-incrimination privilege. A major question regarding the scope of the privilege is the extent to which it protects against penalties not imposed by traditional criminal prosecutions but which nevertheless have serious punitive effects on the individual. In other words, the concept of incrimination needs further clarification by a better definition of what proceedings have the potential to impose criminal sanctions within the scope of the fifth amendment.

According to Justice Frankfurter in *Ullman,* " 'the interdiction of the Fifth Amendment operates only where a witness is asked to incriminate himself,—in other words, to give testimony which may possibly expose him to a criminal charge. But if the criminality has been taken away [by an immunity grant] the

29 *Id.* at 10-11.
30 378 U.S. at 79.
31 *See* note 6 *supra.*

amendment ceases to apply.' "[32] The Court in *Ullman* went on to state that "here since the Immunity Act protects a witness who is compelled to answer to the extent of his constitutional immunity, he has of course, when a particular sanction is sought to be imposed against him, the right to claim that it is criminal in nature."[33]

Courts have taken two different approaches to determine whether particular proceedings are criminal in nature. The first approach involves an examination of the legislative intent and the judicial purpose of the proceeding. In *Trop v. Dulles,*[34] the Supreme Court used this approach to determine that a statute that revoked citizenship for desertion from the military was penal and therefore subject to the eighth amendment's prohibition against cruel and unusual punishment. The Supreme Court stated that, "If the statute imposes a disability for the purposes of punishment—that is, to reprimand the wrongdoer, to deter others, etc.—it has been considered penal. But a statute has been considered nonpenal if it imposes a disability, not to punish, but to accomplish some other legitimate governmental purpose."[35]

The *Daley* court cited two cases, *Boyd v. United States*[36] and *United States v. United States Coin and Currency,*[37] which both took this first approach. In *Boyd,* the Supreme Court held that when a federal prosecutor has the option under a statute of pursuing a civil forfeiture action or a criminal indictment and a violation of law must be found to impose forfeiture, the civil forfeiture proceeding, though nominally civil, is to be treated as criminal for the purposes of the fifth amendment. In *United States Coin and Currency,* the Supreme Court examined the government's institution of civil forfeiture proceedings to recover gambling money from an individual arrested for failure to file and pay gambling taxes. The Court ruled that the forfeiture amounted to a fine and that the privilege against self-incrimination therefore applied: "When the forfeiture statutes are viewed in their entirety, it is manifest that they are intended to impose a penalty only upon those who are significantly involved in a criminal enterprise."[38]

This approach of looking to legislative intent and judicial purpose to determine the character of a proceeding was followed by the *Daley* court in finding that bar disciplinary proceedings are not criminal in nature. The court cited an earlier opinion by the Seventh Circuit as precedent: "They [disbarment and suspension proceedings] are not for the purpose of punishment, but rather seek to determine the fitness of an officer of the court to continue in that capacity and to protect the courts and the public from the official ministration of persons unfit to practice."[39]

The *Daley* court defined the type of proceeding that is within the scope of the fifth amendment as follows:

32 350 U.S. at 431 (quoting Hale v. Henkel, 201 U.S. 43, 67 (1906)).
33 350 U.S. at 431.
34 356 U.S. 86 (1958).
35 *Id.* at 96.
36 116 U.S. 616 (1886).
37 401 U.S. 715 (1971).
38 *Id.* at 721-22.
39 549 F.2d 469 at 475 (quoting In Re Echeles, 430 F.2d 347, 349-50 (7th Cir. 1970)).

> Thus, a clear distinction exists between proceedings whose essence is penal, intended to redress criminal wrongs by imposing sentences of imprisonment, other types of detention or commitment, or fines, and proceedings whose purpose is remedial, intended to protect the integrity of the courts and to safeguard the interests of the public by assuring the continued fitness of attorneys licensed by the jurisdiction to practice law. The former type of proceeding is, in actuality, "criminal" in nature and therefore within the ambit of the Fifth Amendment safeguards against self-incrimination; the latter is not.[40]

The Seventh Circuit enjoys considerable support from state courts in taking this approach. Almost uniformly, they hold that bar disciplinary proceedings are not criminal in nature but rather civil or *sui generis*.[41]

An alternative analysis was available to the *Daley* court in determining whether bar disciplinary proceedings are criminal in nature. The Supreme Court has sometimes determined the nature of legal proceedings by analyzing the impact on the individual and the importance of constitutional safeguards to a fair proceeding. In this second approach, the Court looks beyond the avowed purpose of the proceeding to examine its effect on the individual and balances his interest against that of the state. The balancing approach is a flexible one. It is possible that a court could find that a proceeding is "criminal" for purposes of some constitutional safeguards and not "criminal" for others. For example, a proceeding might be of sufficient criminal character to require the kind of notice of the charge necessary to a criminal proceeding but not of sufficient criminal character to require proof beyond a reasonable doubt.[42]

In *In Re Ruffalo*,[43] the Supreme Court held that an attorney is entitled to notice of the charge against him in a disciplinary proceeding on due process grounds. The Court considered the nature of the proceeding and its possible effect on the attorney. According to the Court, "[d]isbarment, designed to protect the public, is a punishment or penalty imposed on the lawyer."[44] The Court declared that such proceedings are quasi-criminal in nature. It is clear that the Supreme Court recognized the penal character of the proceeding. Although the *Ruffalo* Court did not explicitly use the balancing approach in determining that notice of the charge against an attorney in bar disciplinary proceedings is required, the Court indicated that such an approach might be apropos by citing *In Re Gault*,[45] a case in which the balancing approach was used to determine the nature of a proceeding.

Gault involved the determination of necessary due process safeguards in a

40 549 F.2d at 475.

41 *See* Maryland State Bar Ass'n v. Sugarman, 273 Md. 306, 329 A.2d 1 (1974), *cert. denied*, 420 U.S. 974 (1975); In Re Schwartz, 51 Ill. 2d 334, 282 N.E.2d 689, *cert. denied*, 409 U.S. 1047 (1972); Louisiana State Bar Ass'n v. Ponder, 263 La. 743, 269 So. 2d. 228 (1972); Kelly v. Greason, 23 N.Y.2d 368, 244 N.E.2d 456. 296 N.Y.S. 2d 937 (1968); Black v. State Bar of California, 7 Cal. 3d 676, 499 P.2d 968, 103 Cal. Rptr. 288 (1968); In Re Rouss, 221 N.Y. 81, 116 N.E. 783 (1917), *cert. denied*, 246 U.S. 661 (1918).

42 Although the *Daley* court did not use the balancing approach, it did state in a footnote that not all procedural safeguards are required in bar disciplinary proceedings and that the determination that some are required does not automatically transform the proceeding into one that is criminal in nature. 549 F.2d at 476 n.5.

43 390 U.S. 544 (1968).

44 *Id.* at 550.

45 387 U.S. 1 (1967).

juvenile proceeding. The Court held that juvenile proceedings are criminal for purposes of the fifth amendment. In making that determination the Court focused on the possibility of incarceration involved in a juvenile proceeding. The social stigma attached to an adjudication of delinquency[46] and the harsh discipline dealt out by an adversary authority[47] also contributed to the Court's perception of the penal character of the proceedings. Of course, disbarment also results in significant social stigma, and bar disciplinary proceedings can result in the imposition of harsh discipline.

In *Spevach v. Klein*,[48] the Supreme Court noted the severity of punishment that can result from a bar disciplinary proceeding. In that case the Court ruled that an attorney cannot be disbarred solely because he asserts the privilege against self-incrimination. The Court held that the protection of the fifth amendment privilege "should not be watered down by imposing dishonor of disbarment and the deprivation of a livelihood as a price for asserting it."[49] There was no grant of immunity in *Spevach* which would have protected the attorney against use of his testimony in a traditional criminal case. It is significant, however, that the Court recognized the severe consequences of disbarment and used a violation of the privilege to overturn a disbarment.

In *Erdmann v. Stevens*,[50] the Second Circuit similarly recognized the severe impact of bar disciplinary proceedings. The court characterized them as follows:

> [I]n our view a court's disciplinary proceeding against a member of its bar is comparable to a criminal proceeding . . . It cannot be disputed that for most attorneys the license to practice law represents their livelihood, loss of which may be a greater punishment than a monetary fine . . . Furthermore, disciplinary measures against an attorney, while posing a threat of incarceration only in cases of contempt, may threaten another serious punishment—loss of professional reputation . . . Undoubtedly these factors played a part in leading the Supreme Court to characterize disbarment proceedings as being "of a quasi-criminal nature."[51]

The punitive effect of bar disciplinary proceedings was clearly of importance to the *Erdmann* and *Ruffalo* courts.

The Seventh Circuit distinguished *Ruffalo* and *Erdmann* on the ground that neither involved application of the privilege against self-incrimination. Nevertheless, both courts characterized bar disciplinary proceedings as punitive. Recognition of the punitive effects is of crucial importance in balancing the interests of the attorney against those of the state to determine what constitutional safeguards apply.

Even if the *Daley* court had used the balancing approach, however, it might have reached the same conclusion. The crucial test in applying the balancing approach to determine whether bar disciplinary proceedings are criminal for the purposes of the self-incrimination clause of the fifth amendment, and therefore

46 *Id.* at 24.
47 *Id.* at 26.
48 385 U.S. 511 (1967).
49 *Id.* at 514.
50 458 F.2d 1205 (2d Cir.), *cert. denied*, 409 U.S. 889 (1972).
51 *Id.* at 514.

for the purposes of an immunity statute, is whether the state's interest in maintaining high standards in its practicing bar outweighs the interest of an attorney in remaining silent and thereby protecting his source of livelihood. An attorney is expected to maintain the highest moral standards.[52] This requirement is necessary because of a lawyer's roles as an officer of the court and fiduciary of his client. The danger of harm to third parties and the potential damage to the integrity of the courts as a result of the machinations of one unfit to practice law are weighty considerations that favor the state's interest in not allowing the privilege against self-incrimination and immunity to protect against disbarment. A court would suffer a grave indignity by allowing a lawyer, clearly unfit to practice, to represent clients before it. Such a consequence is not unlikely should attorneys be able to stymie bar disciplinary investigations in this way.[53]

On the other hand, it is undeniable that although disciplinary proceedings are ostensibly meant to protect the courts and public, they carry serious punitive consequences for the attorney.[54] In light of the fact that loss of citizenship[55] and exclusion from public employment[56] have been classified as penal for constitutional purposes, it would not be unreasonable to classify bar disciplinary proceedings as criminal for purposes of the fifth amendment. Such a classification would serve many of the policies of the fifth amendment, including:

> our unwillingness to subject those suspected of crime to the cruel trilemma of self-accusation, perjury or contempt; our preference for an accusatorial rather than an inquisitorial system of criminal justice . . . "a fair state-individual balance by requiring the government to leave the individual alone until good cause is shown for disturbing him and by requiring the government in its contest with the individual to shoulder the entire load."[57]

Although the *Daley* court did not examine *Gault* or *Spevach* in its opinion, both of which dealt with the privilege against self-incrimination, both cases are distinguishable from *Daley*. Although the general punitive elements involved in juvenile proceedings in *Gault* were factors in the Court's determination that the fifth amendment applied, the crucial factor appeared to be the possibility of incarceration, an element not present in bar disciplinary proceedings. *Spevach* is distinguishable on the ground that it dealt with whether an attorney could be disbarred simply for asserting the privilege against self-incrimination, rather than whether the privilege was intended to protect against sanctions imposed by bar disciplinary proceedings.

Nevertheless, the Supreme Court and the Second Circuit have both recognized the penal nature of suspension and disbarment. Any use of the balancing approach to determine what is a criminal sanction for the purposes of the fifth amendment must take cognizance of the weighty judicial authority that characterizes bar disciplinary proceedings as penal in nature.

52 *See* American Bar Association, Code of Professional Responsibility (1976).
53 385 U.S. 511, 521 (1967) (Harlan, J., dissenting).
54 *See* text accompanying note 49 *supra*.
55 Trop v. Dulles, 356 U.S. 86 (1958).
56 United States v. Lovett, 328 U.S. 303 (1946).
57 378 U.S. at 55.

V. Interpreting 18 U.S.C. §§ 6001-03

Although the *Daley* court did not use the balancing approach in determining that bar disciplinary proceedings are not within the imperatives of the fifth amendment, the court did indicate that the approach was used in construing whether the immunity statute under which Daley was ordered to testify, 18 U.S.C. §§ 6001-03, protected Daley against the use of his testimony in bar disciplinary proceedings.

As previously noted, an immunity statute must provide protection coextensive with the fifth amendment. Yet there is no prohibition against a statute conferring immunity broader than fifth amendment imperatives.[58] Therefore the question arose in *Daley* whether 18 U.S.C. §§ 6001-03 protected Daley against use of his testimony before the Illinois Attorney Registration and Disciplinary Commission.

Congress enacted 18 U.S.C. §§ 6001-03 in 1970. It was designed as a comprehensive immunity provision to replace a plethora of existing statutes. The impetus for the reform came from the National Commission on the Reform of the Federal Criminal Laws. In addition to recommending adoption of the use and derivative use standard which *Murphy* indicated would be coextensive with the fifth amendment, the Commission also recommended deletion of the provision in immunity statutes that protected against "penalties and forfeitures" beyond traditional criminal prosecutions.[59] It was the intention of the Commission to limit the protection provided by immunity statutes to that provided by the fifth amendment. The Commission reasoned that because the fifth amendment contained no penalty and forfeiture clause and because the origin of the clause was obscure, there was no need to include such a provision in a comprehensive statute.[60] The Commission, however, recommended that the judiciary determine the scope of the concept of incrimination, stating: "It would seem sufficient for an immunity statute to be worded, as is the fifth amendment itself, in terms of protecting against 'incriminating' consequences of compelled disclosures, and to let the scope of this concept develop judicially in the process of interpreting the fifth amendment."[61] Congress thus left it to the courts to determine what penalties and forfeitures are within the scope of the fifth amendment.

The *Daley* court determined that bar disciplinary proceedings are not within the scope of protection afforded by the fifth amendment and therefore that the immunity statute need not protect against use of compelled testimony in such proceedings. The court also recognized the "paramount interest" of the states "in requiring high standards for their attorneys."[62] This factor, according to the court, "mitigates against a broad construction of 18 U.S.C. §§ 6001-03. . . ."[63]

58 Reina v. United States, 364 U.S. 507 (1960).

59 National Commission on the Reform of the Federal Criminal Laws, Working Papers, at 1405-44. Federal immunity statutes had been modeled on the language of the 1893 amendment to the Interstate Commerce Act. The amendment provided protection against prosecutions and "any penalty or forfeiture." *See* text accompanying note 14, *supra*.

60 National Commission on the Reform of the Federal Criminal Laws, Working Papers, at 1414-16.

61 *Id.* at 1414.

62 549 F.2d at 477.

63 *Id.*

Although the Seventh Circuit did not explicitly weigh the interests of the attorney against those of the state, the court's emphasis on the "paramount interest" of the state indicates a policy choice against the attorney.

VI. Disposing of the Sub-Issues

Daley's immunity grant specifically purported to prevent use of his compelled testimony in bar proceedings against him. After determining that such protection was not mandated by the fifth amendment or the immunity statute, the only issues left to resolve were whether the U.S. Attorney or the district court could confer immunity broader than that contemplated by the statute and whether the district court was estopped from refusing to enforce its order granting immunity. The Seventh Circuit's resolution of those issues was a logical consequence of its other findings limiting the scope of the privilege against self-incrimination. The court concluded that neither the federal prosecutor nor the district court possessed authority to extend the protection in issue.

The decision to confer immunity is based on a weighing of the public need for the testimony against the need to prosecute a violation of the law. The *Daley* court noted this and concluded: "Therefore, the relative importance of particular testimony to federal law enforcement interests is a judgmental rather than a legal determination, one remaining wholly within the competence of appropriate officials, i.e., the United States Attorney with the approval of the Attorney General or his delegate."[64] Because the decision to extend immunity is an executive prerogative, the judiciary must be cautious not to infringe on executive power. The judiciary, however, was clearly accorded a role in the conferral of immunity authorized by 18 U.S.C. §§ 6001-03. The district court issues the order to compel testimony and grant immunity.[65] Although this might at first glance appear to conflict with the executive power, the statute couches the role of the court in purely ministerial terms. As long as the request from the executive conforms to the statutory requirements, the district court must issue the order. The statute uses the ministerial words "shall issue" rather than the discretionary words "may issue."[66] Justice Frankfurter indicated in *Ullmann* that as long as a court's duty is confined to determining that the statutory requirements are met a court remains within the scope of judicial authority and does not infringe on the executive prerogative.[67] The Seventh Circuit accurately concluded that a federal court may not prescribe immunity on its own initiative but rather must "exercise no discretion beyond the statutory authorization."[68]

The immunity power originates in Congress but is delegated to the executive.[69] Therefore, the extent of the authority of the federal prosecutor to grant immunity is limited to the statutory authorization. The *Daley* court, after determining that 18 U.S.C. §§ 6001-03 was limited to the imperatives of the fifth amendment and that the fifth amendment privilege against self-incrimination

64 *Id.* at 479.
65 18 U.S.C. § 6003(a) (1970).
66 18 U.S.C. § 6003 (1970).
67 350 U.S. at 434.
68 549 F.2d at 479.
69 United States v. Bryan, 339 U.S. 323 (1950).

did not protect against bar disciplinary sanctions, concluded that the federal prosecutor exceeded his statutory authority. That the U.S. Attorney had desired the broad immunity grant because he felt it was necessary to preserve the integrity of Daley's testimony did not expand his statutory authority. The Seventh Circuit stated that problems with a lying or prevaricating witness are to be handled by prosecutions for perjury or a contempt sanction.[70]

Of course, the federal prosecutor can use his inherent authority to promise to refrain from federal prosecution, but as the Seventh Circuit noted, he cannot bind state authorities by such an informal grant. Only when he acts under authority of a statute can he bind another jurisdiction. A federal prosecutor has no inherent authority over a state bar disciplinary committee.[71] Therefore, neither the federal prosecutor nor the federal district court had authority to protect Daley against use of his compelled testimoney in a state bar disciplinary proceeding.

As the concurring opinion by Judge Pell pointed out, however, there seems to be an inherent injustice when an attorney is told by two branches of the federal government that the testimony he is compelled to give cannot be used against him in proceedings which could result in a substantial penalty against him, only to have those assurances vanish later.[72] Daley argued that since he relied on the broad immunity grant in deciding whether to testify in compliance with the order or to refuse to testify and risk a contempt sanction, the district court was estopped from refusing to forbid use of his testimony by the Illinois Attorney Registration and Disciplinary Commission.[73] If the district court were to allow the use of his testimony, Daley contended, it would be a due process violation.

The Seventh Circuit held that once immunity had been granted, a duty to testify devolved upon Daley. The Seventh Circuit declared that no choice existed: "[S]ince there is no 'choice,' in any sense, to be made by an immunized witness, the breadth of the scope of immunity conferred cannot legitimately be claimed as a 'factor' in an illusory 'choice' of testifying or being adjudged in contempt."[74] Because the duty to give testimony is a duty to give true and complete testimony, any false or evasive testimony that Daley might have given would have lost for him whatever protection the immunity grant did afford.[75] The court concluded that because a grant of immunity less broad than that given Daley would have been sufficient to compel complete and honest testimony from him and because he was only entitled to the narrower grant, there was no due process violation.[76]

VII. Conclusion

The Seventh Circuit's opinion in *In Re Daley* limits the scope of the protection afforded by the self-incrimination clause of the fifth amendment. The court's

70 549 F.2d at 480.
71 *Id.* at 480.
72 *Id.* at 482.
73 *Id.* at 481.
74 *Id.*
75 United States v. Tramunti, 500 F.2d 1334, 1342 (2d Cir.), *cert. denied,* 419 U.S. 1079 (1974).
76 549 F.2d at 482.

classification of bar disciplinary proceedings as remedial rather than penal and therefore not criminal for the purposes of the fifth amendment has considerable case support. Nevertheless, that approach to the problem ignores the very real punitive effects of bar disciplinary proceedings upon the individual attorney. The official view that the purpose of such proceedings is to determine the moral fitness of an attorney and not to punish him ignores the hard realities. Disbarment results in public disgrace and deprivation of means of livelihood, and those consequences should not have gone unaddressed. From an attorney's point of view disbarment is as serious a sanction as a criminal fine or perhaps even imprisonment. It would have been helpful if the Seventh Circuit had acknowledged those punitive consequences, and in addition to the approach it did take, also balanced the state's interest in maintaining high standards in the bar against the attorney's interest against self-incrimination. The court may very well have come to the conclusion that the necessity of protecting the integrity of the courts and of protecting the public against a lawyer unfit to practice law simply outweighs the private interest.

Undoubtedly, the legal profession and the public will continue to suffer from the dishonest activities of a few unworthy members of the bar. Bribery and extortion activity is often difficult to uncover and prosecute without the testimony of "insiders." It is precisely for the reason that such testimony is necessary that Congress enacted immunity provisions which the executive can use to compel unwilling witnesses to testify.

Ironically, the Seventh Circuit's opinion may have the effect of hindering the effectiveness of immunity legislation. Now that it has been made quite clear to attorneys that there is no protection against the use of immunized testimony in disbarment proceedings, even with a specific grant that purports to protect against such an occurrence, it is a fair assumption that some attorneys will lie or hedge their testimony in an effort to avoid disbarment proceedings, thereby hindering investigations and prosecutions. The fear expressed by the U.S. Attorney in *Daley* that the integrity of testimony given by lawyers in an investigation into bribery and corruption rings will suffer may prove well-founded. Just how effective perjury prosecutions and contempt sanctions will be in coping with the problem remains to be seen. The perjury and contempt route is a more uncertain and burdensome way of insuring the integrity of testimony than the extension of immunity grants to bar disciplinary proceedings. Because *In Re Daley* is a typical response to the fifth amendment in relation to immunity statutes, and because the response may have the effect of impairing the effectiveness of such immunity statutes, Congress should consider extending immunity protection to bar disciplinary proceedings.

Gregory G. Murphy

II. Conflict of Laws

CONFLICT OF LAWS—STATUTES OF LIMITATION—A GENERAL STATUTE OF LIMITATIONS MAY BE READ IN CONJUNCTION WITH ANOTHER STATUTE TO SATISFY THE SPECIFICITY EXCEPTION TO *Lex Fori* RULE.

*Kalmich v. Bruno**

Introduction

In diversity cases, it is usually held that the substantive law of the place where the injury occurred determines the rights and liabilities of the parties.[1] This is commonly referred to as the *locus delicti* rule. An exception to this rule exists, however, where another state has a more significant relationship with the litigants and their controversy. In such situations, the law of that other state is applied.[2]

Statutes of limitation are considered procedural rather than substantive law in most states. As a result, the limitations law of the forum (*lex fori*) is frequently enforced in diversity cases notwithstanding the statute of limitations of the substantive law jurisdiction. This general rule also has a common exception, labelled the "specificity test": where the time limitation is an integral part of the statute creating the substantive right[3] or the limitation is in another statute but is specifically directed at the statute creating the right,[4] the forum court will recognize and enforce that limitation provision from the foreign jurisdiction.

In *Kalmich v. Bruno,* the District Court for the Northern District of Illinois applied the substantive law of Yugoslavia to the facts of the case. During the Nazi occupation of Yugoslavia in World War II, plaintiff Kalmich's business and property were confiscated and later sold by defendant Bruno, a German officer. The defendant enjoyed substantial personal gain from the transaction. Kalmich spent considerable time and expense searching for Bruno until May of 1972, when he discovered the defendant living in Chicago and commenced this lawsuit.

Plaintiff's cause of action was based on Article 125 of the Yugoslavian Criminal Code, which provides that anyone who confiscated belongings of another during World War II for nonmilitary purposes would be subject to criminal prosecution. In addition, three other Yugoslavian statutes were relevant to the case. Article 134(a) provides that there shall be no statute of limitations upon the prosecution of violators of Article 125; Section 1 of the "Law Concerning the Treatment of Property. . . Taken Away from the Owner by the Enemy or its Helpers" provides a civil cause of action for those whose belongings were confiscated by the German occupation force; and, Section 20 of the Yugoslavian Statute of Limitations provides that the statute of limitations upon criminal actions shall serve as the statute of limitations upon civil actions if the conduct

* 553 F.2d 549 (7th Cir. 1977).
1 2 BEALE, TREATISE ON THE CONFLICT OF LAWS 1286-92 (1935).
2 Ingersoll v. Klein, 46 Ill. 2d 42, 262 N.E.2d 593 (1970).
3 The Harrisburg, 119 U.S. 199 (1886).
4 Davis v. Mills, 194 U.S. 451 (1904).

complained of in the civil action could subject the defendant to a criminal prosecution.[5]

The district court was thus confronted with the complex problem of deciding which statute of limitations should be applied—that of the forum under the *lex fori* rule, or that of the *locus delicti* because the limitation provision was specifically directed to the statutory right and should be enforced with the otherwise applicable substantive law. The specificity test is satisfied with respect to *criminal* prosecutions of war crimes because there exists an adequately specific reference in the limitations law (Article 134(a)) to warrant application of that limitation. But the limitation of the similar civil cause of action was derived from a very general statute of limitations (Section 20) which provided that certain civil causes of action acquired their limitation periods from the corresponding criminal action.

The district court recognized Section 20 of the Yugoslavian Statute of Limitations as a general statute of limitations not specifically directed to the statutory right upon which plaintiff based his claim. As a consequence, the court held that this limitation provision was not substantive law and the limitations period of the forum would be enforced. The court accordingly dismissed the complaint as barred by Illinois' five-year statute of limitations.[6]

The Seventh Circuit reversed and remanded that decision, concluding that the plaintiff could maintain the action despite the Illinois statute of limitations. The court indicated that the specificity test was the proper test to be applied, and concluded that the facts of this case fell within the specificity exception. In other words, the court held that the Yugoslavian limitations law was specifically part of the substance of the foreign statutory right and thus was the properly applicable limitations rule.

The court arrived at this conclusion despite the fact that the Yugoslavian provision is essentially a general statute of limitations. A proper application of the specificity test, however, requires a limitations provision that is specifically directed at the statute creating the substantive right. The approach adopted by the court was thus an improper utilization of the specificity test. An alternative choice of limitations rule was available to the court, however, to determine the applicable limitations provision to be applied in the instant case: the significant relationship test. An application of the significant relationship test to the statute of limitations issue in this case would have provided more proper grounds for the court's result.

The Choice of Law Question

A well-established principle of the federal judicial system is that a federal court exercising diversity jurisdiction is bound by the substantive law of the state in which it sits.[7] The forum state's choice of law rules, when the laws of different jurisdictions are in issue, are included in the "substantive law" definition.[8] Regarding the "choice of law" rules, Illinois courts apply the "most sig-

5 Kalmich v. Bruno, 553 F.2d 549, 551 (7th Cir. 1977).
6 ILL. REV. STAT. ch. 83, § 22 (1975).
7 Erie RR Co. v. Tompkins, 304 U.S. 64 (1938); 28 U.S.C. § 32.
8 Klaxon Co. v. Stentor Elec. Mfr. Co., 313 U.S. 487 (1941); Griffin v. McCoach, 313 U.S. 498 (1941).

nificant relationship" test. This test was set forth in *Ingersoll v. Klein.*[9] The court observed that, while the substantive law of the jurisdiction where the injury occurred normally determines the rights and liabilities of the parties, if the forum "has a more significant relationship with the parties . . . the law of [the forum] should apply."[10]

Because the great majority of American courts, including Illinois, regard statutes of limitation as procedural matters,[11] diversity courts are often confronted with the complex issue of deciding the proper statute of limitations to be enforced. The general rule is that the limitations period is controlled by the *lex fori,*[12] but the numerous exceptions to the rule which have evolved lend considerable confusion to this area of conflict of laws.

The Lex Fori *Rationale*

The most common reason offered by courts adopting the *lex fori* rule, that rule which prefers the statute of limitations of the forum state in choice of law matters, is that this limitation affects only the *remedy* of the parties and not their substantive rights.[13] Behind this logic is the assumption that the *locus lexi* which creates the substantive right does not extinguish that right by virtue of its statute of limitations. The applicable time period is designated as a merely procedural consideration intended to bar the remedy in the courts of that jurisdiction after that period has lapsed. By this assumption, the substantive right is still in existence and, presumably, is still enforceable in the proper jurisdiction. The courts continue to apply the procedural rules of the forum despite the fact that, in some cases, the substantive rights of the parties are exclusively established by the local law of another state. Consequently, an individual whose cause of action is barred by the local statute of limitations could take his action to another forum having jurisdiction over the matter[14] to take advantage of the longer statute of

9 46 Ill. 2d 42, 262 N.E.2d 593 (1970).

10 *Id.* at 44, 262 N.E.2d at 595. In Kalmich v. Bruno, both the district court (404 F. Supp. at 61-63) and the Court of Appeals (553 F.2d at 552) agreed that Yugoslavia had the more significant relationship with the parties and Yugoslavian law should govern in this case.

11 Hilberg v. Industrial Comm'n., 380 Ill. 105, 43 N.E.2d 671 (1942); 15A C.J.S. *Conflict of Laws* § 22(5) (1967); Lorenzen, *Statutes of Limitation and the Conflict of Laws* 28 YALE L.J. 492 (1919).

12 RESTATEMENT OF CONFLICT OF LAWS § 603 (1934).

13 Jackson v. Shuttlesworth, 42 Ill.App. 2d 257, 260, 192 N.E.2d 217 (1963); Horan v. New Home Sewing Machine Co., 289 Ill.App. 3401, 7 N.E.2d 401 (1937); Wetzel v. Hart, 41 Ill.App.2d 371, 190 N.E.2d 619 (1963); A. DECERVERA, THE STATUTE OF LIMITATIONS IN AMERICAN CONFLICT OF LAWS § 1 (1966); R. LEFLAR, AMERICAN CONFLICTS LAW § 127 (rev. ed. 1968); Lorenzen, *The Statute of Limitations and the Conflict of Laws* 28 YALE L.J. 492 (1919); McEmoyle v. Cohen, 38 U.S. (13 Pet. 312) (1839).

14 Assuming a particular court has subject matter jurisdiction, a second question is whether it has jurisdiction over the parties. The plaintiff, by bringing his cause of action in a given forum has thereby submitted himself to the court's jurisdiction. The defendant may be sued in any jurisdiction in which he can be served with process. The defendant's domicil (Milliken v. Meyer, 311 U.S. 457 (1940)), citizenship (Blackmer v. United States, 284 U.S. 421 (1932)), place of residence (RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 30 (1971)), or actual consent (RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 32 (1971)) will provide the basis for personal jurisdiction. A corporation may impliedly consent to jurisdiction by doing business in that state (R. LEFLAR, AMERICAN CONFLICTS LAW 56-58 (1968)) or even in some cases, having certain minimum contacts with the jurisdiction (Int'l Shoe Co. v. Washington, 326 U.S. 310 (1945). Long arm statutes play an important role in this jurisdictional scheme (*see* M. GREEN, BASIC CIVIL PROCEDURE 31-36 (1972)).

limitations. The plaintiff could thus enforce a claim which would not be enforced in the jurisdiction in which it arose.

The inherent injustice in "forum-shopping" of this kind was recognized in *Erie Railroad Co. v. Tompkins*,[15] where the Supreme Court held that the accident of diversity of citizenship should not affect the substantive right of the litigants.[16] An early attempt by the Court to implement the philosophy of the *Erie* doctrine occurred in *Guaranty Trust Co. v. York*,[17] in which the Court held that procedural points of state law are to be considered as substantive when they affect the outcome of the case. But subsequent litigation revealed that this outcome-determinative test did not work as planned. The new doctrine could conceivably signal the end of the federal rules of procedure in cases where state substantive law was applied since nearly all of the federal procedural rules may be outcome-determinative in any given case.

The Supreme Court first manifested its misgivings about the outcome-determinative test in *Byrd v. Blue Ridge Rural Electric Cooperative*.[18] In *Byrd*, the Court was reluctant to discard a federal procedural policy concerning jury determination of fact issues although a jury decision may have had a substantive effect on the outcome of the case. The Court partially retreated from its decision in *Guaranty* by holding that a state rule must be applied if it is an integral part of a state created right. But, the Court continued, a federal rule should be applied if the federal interest is great enough regardless of the result of the outcome-determinative test.

The Court took this qualification of the outcome-determinative test one step further in *Hanna v. Plumer*.[19] In that case, a question arose as to which was the proper statute of limitations: the federal or the state provision. The Court held that where a point of law is specifically covered by one of the federal rules, and unless the rule cuts so deeply into substance as to go beyond the power of the Supreme Court to promulgate it under the enabling act, the federal rule must be applied.[20] Some commentators have gone so far as to say that *Hanna* stands for the proposition that whenever a federal rule is in direct conflict with a state law, the federal rule prevails even if its application would be outcome-determinative.[21] In any event, application of the outcome-determinative approach was thus severely limited. As a result, less and less reliance has been placed on the outcome-determinative test in choice of law matters.

The demise of the outcome-determinative test forced the courts and legislatures to seek more effective means of limiting forum-shopping. The most common legislative means of limiting application of the *lex fori* rule[22] is through

15 304 U.S. 64 (1938).

16 As Judge Magruder pointedly expressed in Sampson v. Channel, 110 F.2d 754, 756 (1st Cir. 1940), *cert. denied*, 310 U.S. 650 (1940), the opinion in Erie "sets forth as a moving consideration of policy that it is unfair and unseemly to have the outcome of litigation substantially affected by the fortuitous existence of diversity of citizenship." 110 F.2d at 756.

17 326 U.S. 99 (1945).

18 356 U.S. 525 (1958).

19 380 U.S. 460, 468 (1965).

20 M. GREEN, BASIC CIVIL PROCEDURE 7-8 (1972).

21 Comment, *Statutes of Limitations in Diversity Cases: For Whom the Statute Tolls*, 10 CALIF. WEST. L. REV. 131 (1973).

22 The *lex fori* rule is exploited by forum-shoppers who seek out a jurisdiction with a generously long statute of limitations that must be observed by the forum court as part of its procedural law; *see* text accompanying notes 13-26 *supra*.

the promulgation of borrowing statutes that direct courts to bar actions that cannot be maintained because of the statute of limitations of some other state.[23] Which "other state" is relevant depends on the language of the particular borrowing statute. Some statutes look to the state where the cause of action "arose" or "accrued" as controlling the limitations question. Others look to the state which is the plaintiff's domicil or residence during a period subsequent to the act giving rise to the litigation.[24]

In the absence of a borrowing statute, the problem of forum shopping will be addressed judicially. The judge-made remedy has typically focused on the substantive-procedural dichotomy[25] to thwart the plaintiff who brings his cause of action in a jurisdiction solely because it has a longer statute of limitations than the locus jurisdiction. By interpreting a limitations provision as part of the substantive law of the foreign jurisdiction, a court enforces that shorter limitation and disregards the statute of limitations of the forum. A decision of this kind is often framed in language which emphasizes that the foreign limitations provision "conditions" or "qualifies" the statutory right and, as a consequence, must be recognized as part of the foreign substantive law.[26]

Determination of Substance v. Procedure

A number of tests have been invented, debated and modified over the years that are designed to enable courts confronted with this question to determine whether a particular rule of limitations is substantive or procedural.

The original test was devised in *The Harrisburg*,[27] in which the Supreme Court held that a time limitation contained in the same statute which creates the substantive right is to be regarded as a substantive rather than procedural aspect of the foreign law and should be enforced by the forum court. This has been referred to as the "built-in" test because the substantive statute has a built-in time element which accompanies it everywhere and must be recognized in every forum.[28] Courts applying the "built-in" test often make reference to the right-remedy distinction.[29] That is, where a statute that creates a single right of action also contains a provision limiting the time in which actions under the statute may be brought, the statute of limitations bars the right. This is to be distinguished from a purely procedural statute of limitations that bars only the remedy and leaves the right intact—although unenforceable in the forum jurisdiction. Conversely, the expiration of a limitations provision which satisfies the built-in test marks the expiration of the right as well as the remedy.

The most common application of the *Harrisburg* test has traditionally

23 Illinois has a fairly typical borrowing statute: "When a cause of action has arisen in a state or territory out of this state, or in a foreign country, and, by the laws thereof, an action thereon cannot be maintained by reason of the lapse of time, an action thereon shall not be maintained in this state." ILL. REV. STAT. ch. 83, § 21 (1973).

24 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 142, comment f, subsection 1 (1971).

25 The statute of limitations is a procedural concern and, as such, should be derived from the law of the jurisdiction in which the court sits; *see* text accompanying notes 11-12 *supra*.

26 Davis v. Mills, 194 U.S. 451 (1904).

27 119 U.S. 199 (1886).

28 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 143 (1971).

29 *See* text accompanying notes 13-14 *supra*.

been in cases brought under wrongful death statutes. Wrongful death legislation often specifies a shorter limitations period than the general statute of limitations of the forum. In this situation, the forum court will find that the former limitations period should be enforced as part of the substantive law being enforced.[30]

A second test for determining which foreign statutes of limitation are substantive and which are procedural is the "specificity test" which emerged in *Davis v. Mills*.[31] This test broadens the definition of the kinds of limitations provisions that would fall into the category of substantive law in that it was no longer a necessity that the time element appear in the same statute creating the right. If there is some pointed reference in a limitations statute or rule of law that is specifically directed to the statute creating the right, the limitations provision satisfies the substantive law criterion and will be recognized by the court. Justice Holmes, writing for the majority, explained the rationale underlying the "specificity test" as follows:

> [T]he fact that the limitation is contained in the same section or the same statute is material only as bearing on construction. It is merely ground for saying that the limitation goes to the right created, and accompanies the obligation everywhere. The same conclusion would be reached if the limitation was in a different statute, provided it was directed to the newly created liability so specifically as to warrant saying that it qualified the right.[32]

Thus, where a statute in the locus jurisdiction creates stockholder liability for corporate debt and a separate statute specifically relates to that liability and indicates a period within which that liability must be enforced, the limitation is regarded as a condition to the right created and its bar will be enforced in any other jurisdiction in which its enforcement is sought.[33]

In *Goodwin v. Townsend*,[34] the Third Circuit set forth a third possible test which may be used to ascertain whether a foreign jurisdiction's limitations provision is to be regarded as substantive or procedural. The "foreign-characterization" test established in *Goodwin* involves a determination by the bench of how the courts in the foreign jurisdiction have characterized the limitations rule in question. If foreign courts view the statute as part of their substantive law, the forum court will adopt the same view; if the foreign courts view the applicable statute of limitations as procedural, the sitting court will treat it as procedural. For example, where the statute itself is framed in procedural language and has been specifically construed by courts of the locus jurisdiction to operate merely to bar the remedy and not to extinguish the right, the forum court will adopt the procedural characterization of the limitations rule and not enforce it in the forum court.[35]

A number of courts[36] have applied a fourth approach—labelled the "at-

30 Comment, *Conflict of Laws*, 37 J. AIR L. & COM. 235 (1971).
31 194 U.S. 451 (1904).
32 *Id.* at 454.
33 *See* 113, A.L.R. § 162 *Conflict of Laws* (1938).
34 197 F.2d 970 (3rd Cir. 1952).
35 *Id.* at 972-73. *See also* Marshall v. Geo. M. Brewster & Son, Inc., 37 N.J. 176, 180 A.2d 129 (1962); Hughes v. Hinson's Garage, Inc., 9 A.D.2d 1014, 194 N.Y.S.2d 324 (4th Dep't. 1959).
36 Wood & Selick v. Compagnie Generale Transatlantique 43 F. 941 (2d Cir. 1930); Ramsay v. Boeing Co., 432 F.2d 592 (5th Cir. 1970).

tributes test"—to determine the applicability of a foreign limitation. If the statute of limitations has attributes in the state of its enactment which the forum would characterize as substantive then that limitations period will be observed by the forum court.[37] Learned Hand's analysis of applicable French law in *Wood & Selick*[38] is illustrative of this test. Judge Hand observed that under the law of that country, the legal obligation sued upon could be revived by a promise after the statutory period had elapsed. He noted that in American jurisprudence, "[r]evival rests . . . upon historical peculiarities of our procedure."[39] Thus, he concluded, because the limitation rule in the foreign jurisdiction had procedural attributes when viewed in the context of the *lex fori,* the forum court should treat the statute of limitations as procedural.[40]

The four tests described above deal with the issue of substantive versus procedural law. The courts originally sought to make this distinction with the aim of characterizing particular statutes of limitation as substantive law in order to mitigate the problem of forum shopping. The courts sought to avoid situations in which a plaintiff whose cause of action was barred in the jurisdiction where it arose would bring suit in a different jurisdiction solely because it had a longer statute of limitations. By labelling the lapsed limitations provision of the foreign jurisdiction as substantive law and enforcing its bar, the forum could refrain from applying its own statute of limitations. As an inevitable result of the lip service paid to the substantive-procedural distinction, however, courts began using the exception to *allow* suits that were still viable in the jurisdiction in which they arose, but would have been barred under the statute of the forum.[41]

Conflict of Law Rules and Substantive Law

The traditional rule in the conflict of laws area is that the rights and liabilities of the parties are determined by the law of the place where the wrong was committed.[42] This tenet has its foundation in the vested rights doctrine[43]—a right to recover for a foreign tort depends for its existence solely on the law of the jurisdiction where the injury occurred.[44]

The "law of the place" rule has recently been the subject of increasing criticism of commentators.[45] The judicial trend toward abandonment or modifi-

37 Wood & Selick v. Compagnie Generale Transatlantique, 43 F.2d 941 (2d Cir. 1930).
38 *Id.* at 943.
39 *Id.*
40 *See e.g.,* Ramsay v. Boeing Co., 432 F.2d 595 (5th Cir. 1970), (holding that the foreign limitations provision had substantive law attributes and should be enforced by the forum court).
41 Theroux v. Northern Pac. R. Co., 64 F. 84 (8th Cir. 1894); Collins v. Clayton & Lambert Manufacturing Co., 299 F.2d 362 (6th Cir. 1962); Maki v. George R. Cooke, Co., 124 F.2d 663 (6th Cir. 1942); State of Maryland ex rel. Thompson v. Eis Automotive Corp., 145 F.Supp. 444 (D.Conn. 1956); O'Neal v. Nat. Cylinder Gas Co., 103 F. Supp. 720 (N.D.Ill. 1952); Norman v. Baldwin, 152 Va. 800, 148 S.E. 831 (1929).
42 2 BEALE, CONFLICT OF LAWS 1286-92 (1935).
43 Slater v. Mexican Nat. R. Co., 194 U.S. 120 (1904).
44 HANCOCK, TORTS IN THE CONFLICT OF LAWS 30-36 (1942); Reese, *The Ever Changing Rules of Choice of Law,* NEDERLANDS TIJDSCHRIFT VOOR INTERNATIONAL RECHT 389 (1962).
45 RESTATEMENT (SECOND) OF CONFLICT OF LAWS, Introductory Note No. 1 (Tent. Draft No. 9, 1964); STUMBERG, CONFLICT OF LAWS 199-212 (3d ed. 1963); Cavers, *A Critique of the Choice-of-Law Problem,* 47 HARV. L. REV. 173 (1933); Cheatham & Reese, *Choice of the Applicable Law,* 52 COLUM. L. REV. 959 (1952).

cation of the rule mirrors this academic criticism.[46] The basic flaw in the theory is that it ignores the possibly legitimate interest of the other jurisdiction in the resolution of a particular controversy.[47]

In response to the growing dissatisfaction with the doctrine of *lex loci delicti,* two notable alternative choice of law formulas have been adopted in about one-half the states.[48] These are commonly known as the "most significant relationship" test and the "governmental interest-analysis" test.

1. The Most Significant Relationship Test

Tentative Draft No. 9 of Section 379, Restatement (Second) Conflict of Laws reads, "(1) The local law of the state which has the most significant relationship with the occurrences and with the parties determines their rights and liabilities in tort."[49]

This doctrine has been adopted by a considerable number of American courts.[50] On occasion, a court will place maximum emphasis on the number of parties involved in the suit who are related to the particular jurisdiction, or the interests of the parties that will be advanced by the law of the particular jurisdiction.[51] Ideally, according to the proposed Restatement view, in any determination of the most significant relationship, all of the following factors should be taken into consideration:

> (2) Important contacts that the forum will consider in determining the state of most significant relationship include:
> (a) the place where the injury occurred,
> (b) the place where the conduct occurred,
> (c) the domicil, nationality, place of incorporation and place of business of the parties, and
> (d) the place where the relationship, if any, between the parties is centered.
> (3) In determining the relative importance of the contacts, the forum will consider the issues, the character of the tort, and the relevant purposes of the tort rules of the interested states.[52]

When the court looks exclusively to the parties as an indication of which jurisdiction has the most significant relationship, it will often refer to the doctrine as the "significant contacts" approach.[53] But for all practical purposes, the results of the slightly different tests will be the same.

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46 Babcock v. Jackson, 240 N.Y.S.2d 744, 746, 191 N.E.2d 279, 281 (1963).
47 *See* Cheatham & Reese, *Choice of the Applicable Law,* 52 COL. L. REV. 959, 976 (1952).
48 S. Wurfel, *Statutes of Limitation in the Conflict of Laws,* 52 N.C.L. REV. 489, 567 (1974).
49 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 379 (Tent. Draft No. 9 1964).
50 Romero v. International Terminal Operating Co., 358 U.S. 354, 382-83 (1959); Bowles v. Zimmer Manufacturing Co., 277 F.2d 868 (7th Cir. 1960); Grant v. McAuliffe, 41 Cal.2d 859, 264 P.2d 944 (1953); Babcock v. Jackson, 12 N.Y.2d 473, 191 N.E.2d 279 (1963); Roberson v. Bitner, 221 F.Supp. 279 (E.D. Tenn. 1963); Ingersoll v. Klein, 46 Ill.2d 42, 262 N.E.2d 593 (1970).
51 Heavner v. Uniroyal Co., 63 N.J. 130, 305 A.2d 412 (1973).
52 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 379 (Tent. Draft No. 9 1964).
53 Horton v. Jessie, 423 F.2d 722 (9th Cir. 1970).

2. The Governmental Interest-Analysis Test

The second conflict of laws formula that serves as an alternative to the law of the place doctrine is closely related to the Second Restatement approach. While the latter approach scrutinizes all of the factors set forth in the proposed Restatement or places greater emphasis on the role of the litigating parties, the "interest-analysis" doctrine emphasizes the "relevant purposes of the tort rules" mentioned in subsection 3 of tentative draft no. 9, section 379. The "relevant purposes of the tort rules" is translated into the interest that the jurisdiction itself has in the litigation.

This doctrine is probably the most modern choice-of-law technique for deciding substantive questions in tort cases.[54] Under the interest-analysis test, the court is obliged to consider whether the forum jurisdiction's governmental policies would be advanced by applying local substantive law rather than another jurisdiction's law, and if the forum jurisdiction has interests at stake in the litigation, then the court should apply forum law.[55] The court must thus determine the policy expressed by the foreign law, and whether the foreign state has an interest in application of its policy. If the court determines that the forum state has no interest in the application of its policy, but that the foreign state has, it should apply the foreign law. On the other hand, the court will often apply the law of the forum if it finds that the forum state has an interest in the application of its own policy, regardless of whether the foreign state has or does not have an interest in the application of its contrary policy,[56] through the application of various decisional rules of preference.

The distinction between the most significant relationship and the governmental interest-analysis approaches is not altogether obvious. It is not uncommon to find the terms used interchangeably,[57] or to find a reference to an interest-analysis decision which is discussed in the context of significant relationship doctrine or vice versa.[58] In a proper application of the Second Restatement approach, however, the court will focus on the parties involved, the situs of the tort, the injury, etc., rather than on the governmental policy considerations involved.[59]

Conflict of Law Rules and Statutes of Limitation

As a general rule, the two choice-of-law formulas discussed in the preceding sections have been utilized only in the context of determining the substantive law to be applied in a particular case. But in some recent cases, the formulas have been extended to statutes of limitation issues as well. In *Horton v. Jessie,*

54 Currie, *Notes on Methods and Objectives in the Conflict of Laws,* 1959 DUKE L.J. 171, 178; Von Mehren & Trautman, MULTISTATE PROBLEMS 209 (1965).

55 Farrier v. May Dept. Store Co., 357 F.Supp. 190 (D.D.C. (1973)). *See* text accompanying notes 60-63 *supra,* for an illustration of how this policy actually works.

56 B. CURRIE, SELECTED ESSAYS ON CONFLICT OF LAWS 177, 178 (1963).

57 Schenk v. Piper Aircraft Corp., 377 F.Supp. 477 (W.D. Pa. 1974).

58 Kalmich v. Bruno, 404 F.Supp. 57 (N.D. Ill. 1975) (citing the Farrier decision as a significant relationship application); 29 Comment, *Conflicts of Laws: Statutes of Limitation,* OKLA.L.REV. 385 (1976) (referring to Klondike as an interest-analysis decision).

59 *See, e.g.,* Klondike Helicopters Ltd. v. Fairchild-Hiller Corp. 334 F.Supp., 890, 894 (N.D. Ill. 1974).

for example, the Court of Appeals for the Ninth Circuit recognized the applicability of the most significant relationship analysis in a diversity statute of limitations situation.[60]

The governmental interest-analysis approach has also been used to decide whether the statute of limitations of the forum or that of the situs of the tort should be applied to the case. In *Henry v. Richardson-Merrel, Inc.*,[61] plaintiff, a thalidomide baby born in Quebec, brought suit in New Jersey against the drug manufacturer. The Quebec one-year statute of limitations had run but the action was still within the longer New Jersey statute. In holding that the Quebec statute was properly applicable and that plaintiff's action was therefore barred, the court of appeals emphasized that enforcing the plaintiff's claim would not further New Jersey's interest in deterrence because the drug company's decision to manufacture, test and distribute thalidomide was made in Ohio, not New Jersey. Likewise, the state's second jurisdictional interest, compensation, would not be advanced by enforcement of the claim because the limitation provision was designed to benefit New Jersey plaintiffs, not Quebec citizens. Conversely, the court found that Quebec's interests would be served by barring the claim. Nonenforcement would advance Quebec's express policy of repose for the benefit of defendants doing business in Quebec[62] and of judicial economy by discouraging stale claims.[63] Thus, the court advanced the policies of the only interested state and barred plaintiff's action.[64]

Other recent decisions, however, have emphatically rejected the use of either interest analysis or the Second Restatement formula[65] as applied to the forum's statute of limitations. In *Schenk v. Piper Aircraft Corp.*,[66] for example, the District Court for the Western District of Pennsylvania declined employment of the interest-analysis test, stating that the test simply has no application to the interjurisdictional statute of limitations area.[67] Thus, while some courts have adopted the interest analysis approach in addressing statute of limitations questions, other courts have held fast to the time-honored substantive-procedural distinction and declined to use the new approach.

Similarly, the Third Circuit rejected the Second Restatement approach in

60 In Horton v. Jessie, 423 F.2d 722 (9th Cir. 1970), the court concluded that "[u]nder the California significant contacts approach, we find too little Missouri significant contacts and too many in California to apply the Missouri statute." In a later decision though, Klingebiel v. Lockheed Aircraft Corp., 372 F.Supp. 1086 (N.D. Col. 1971), the district court held that Horton was not intended to be an unequivocal adoption of the significant contacts approach in applying the California statute of limitations; the substance-procedure dichotomy was supposedly still viable in that state.

61 508 F.2d 28 (3rd Cir. 1975).

62 *Id.* at 38.

63 But that court protected policy was not applicable in Henry because the case was not before a Quebec court. *See* G. Millhollin, *Interest Analysis and Conflict between Statutes of Limitation,* 27 HASTINGS L.J. 1 (1975).

64 Farrier v. May Dept. Store Co., 357 F.Supp. 190 (D.D.C. 1973); Dindo v. Whitney, 429 F.2d 25 (1st Cir. 1970); Heavner v. Uniroyal Co., 63 N.J. 130, 305 A.2d 412 (1973) are cases supporting the proposition that the interest-analysis approach is applicable to statutes of limitation as well as substantive law.

65 Chartner v. Kice, 270 F.Supp. 432 (E.D. N.Y. 1967); Klondike Helicopters Ltd. v. Fairchild-Hiller Corp., 334 F.Supp. 890, 894 (N.D. Ill. 1971).

66 377 F. Supp. 477 (W.D. Pa. 1974).

67 The court cited Mack Trucks, Inc v. Bendix-Westinghouse Auto. A.B. Co., 372 F.2d 18 (3rd Cir. 1966) which in fact rejects the significant contacts test, not interest-analysis.

Mack Trucks, Inc. v. Bendix-Westinghouse Automatic Airbrake Co.,[68] adhering to a strict application of the Pennsylvania borrowing statute. However, the dissent in the case voiced support of the significant contacts approach. Judge Freedman's dissent declared that Pennsylvania is in the forefront of states that have adopted a new pragmatic standard regarding choice of law which "eschews mechanical formulas."[69] This formula also effectively deals with forum shopping problems and "emphasizes a principle of realism in preference to an automatic test applied by a rule of thumb."[70] Judge Freedman went on to say that he saw no reason to restrict modern-day conflicts formulas to substantive law. Although limitations provisions are labelled "procedural" concerns, to the party whose suit is barred the distinction between right and remedy has little significance.[71]

Criticism of the Substantive-Procedural Dichotomy and Suggested Alternatives

Echoing the sentiments of Judge Freedman, many commentators have been highly critical of the right-remedy/substance-procedure distinction. Five basic criticisms and alternative proposals have evolved. One argument objects to the distinction on the ground that a statute of limitations is not a rule of procedure because it does not really affect the method of presentation of the cause of action but is determinative of whether the party is allowed into court to offer any proof at all.[72] By the same token, a second common criticism emphasizes that the distinction fails to recognize that a "right" does not have an independent existence from the remedy when the right can exist only if the courts of that jurisdiction will enforce it and give a remedy for its breach.[73]

A third attack on right-remedy/substance-procedure analysis is set forth by Professor Lorenzen. He argues that after enforcement of the cause of action is no longer available under the law governing the rights of the parties, that same effect should attach everywhere.[74] If the foreign jurisdiction has a longer statute of limitations and the shorter period of the forum has expired, the suit should also be barred. The forum's interests in the administration of justice within its borders prevail, so the designated period prescribed by the forum must apply to all causes of action regardless of the place where they may have arisen.[75]

A fourth criticism, recognizing that the line drawn between substance and procedure is not clearly delineated, proposes that a court should adopt the foreign procedural rule whenever it can do so without "inconveniencing" itself by taking over too much foreign law. Since statutes of limitation are relatively convenient to ascertain, it is obvious that the foreign time period would be classified as substantive law.[76]

A fifth alternative is advanced by Professor Sedler who argues that the courts

68 372 F.2d 18 (3rd Cir. 1966).
69 *Id.* at 23.
70 *Id.*
71 *Id.* at 24.
72 Comment, *Conflict of Laws* 37 J. AIR L. & COM. 235, 237 (1971).
73 J. FALCONBRIDGE, CONFLICT OF LAWS § 241.43 (1947).
74 Lorenzen, *Statutes of Limitation and the Conflict of Laws* 28 YALE L.J. 492, 496 (1919).
75 *Id.*
76 Cook, *"Substance" and "Procedure" in the Conflict of Laws,* 42 YALE L.J. 333, 343-44.

should follow the explicit doctrine of *Guaranty Trust Co. v. York*,[77] that is, the outcome-determinative test discussed above. The foreign statute of limitations should be applied whenever it would affect the outcome of the litigation. This simple tenet derives from the *Guaranty* Court's interpretation of the intent of *Erie RR Co. v. Tompkins*:[78] "to insure that . . . the outcome of the litigation in the federal court should be substantially the same . . . as it would be if tried in a State Court."[79]

Although the "black letter" portion of the Restatement (Second) of Conflict of Laws § 122[80] follows the traditional view, there is a pronounced rejection of the distinction between substance and procedure in the comment discussion. The Restatement criticizes "unthinking adherence to precedents that have classified a given issue as 'procedural' or 'substantive,' regardless of what purposes were involved in the earlier classifications" and encourages a case-by-case analysis of whether the forum's rule should be applied.[81]

For the most part, these criticisms and suggestions would have the courts apply various choice of law formulas to the statute of limitations so as to actually treat the statute as substantive law. By seeking to discard the substantive-procedural dichotomy, the Restatement advocates the same result, as do numerous other commentators.[82]

The Specificity Test as Applied to Kalmich v. Bruno

In the instant case, plaintiff Kalmich, a citizen of Quebec, brought an action against defendant Bruno, a citizen of Illinois, in United States District Court for the Northern District of Illinois.[83]

Alleging that the defendant unlawfully confiscated his textile business in 1941, plaintiff based his cause of action on four Yugoslavian statutes:[84] Article 125 of the Criminal Code subjected anyone who confiscated belongings of another during World War II, for nonmilitary purposes, to criminal prosecution for those acts; Article 134(a) provides that there shall be no statute of limitations upon the prosecution of those accused of violations of Article 125; Section 1 of the "Low Concerning the Treatment of Property . . . Taken Away from the Owner by the Enemy or its Helpers" provides those whose belongings were confiscated by the German occupation force with a civil cause of action against the perpetrators; and, Section 20 of the Yugoslavian Statute of Limitations provides that if conduct complained of in a civil action could subject the defendant to a criminal prosecution, then the statute of limitations upon that criminal action shall serve as the statute of limitations upon the related civil action.[85]

77 326 U.S. 99 (1945).
78 304 U.S. 64 (1938).
79 326 U.S. 99, 109 (1945).
80 RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 122 (1969).
81 *Id.*, comment b at 352.
82 Ester, *Borrowing Statutes of Limitation and Conflict of Laws,* 15 U. FLA. L. REV. 33 (1962); 10 CALIF. WESTERN L. REV. 131, 142 (1973); Comment, *Conflict of Laws* 37 J. AIR L. & COM. 235 (1971).
83 404 F.Supp. 57 (N.D. Ill. 1975).
84 These were pleaded in the complaint to provide the notice of foreign law issues required by Rule 44.1, FED. R. CIV. P.
85 Kalmich v. Bruno, 553 F.2d 549, 551 (7th Cir. 1977).

Section 1 provided the plaintiff with the substantive right he is attempting to enforce—it furnished a cause of action against those who confiscated his belongings during the war. Section 20 was the applicable statute of limitations, stating that if a defendant's conduct in the civil action could subject him to a criminal prosecution, then the statute of limitations for the civil action is the same as the statute of limitations for the corresponding criminal action. Article 125 (which makes confiscating the belongings of another during World War II a criminal offense) is that corresponding criminal action. The statute of limitations provision for Article 125 is Article 134(a) which says that there are no time limitations on prosecutions of Article 125 violators. The applicable statute of limitations for Section 1 is thus determined by looking to the general statute of limitations for civil actions (Section 20) which directs us to the corresponding criminal action that derives its statutory enforcement period from Article 134(a). In other words, because there is no statute of limitations on the criminal prosecution of certain war crimes, Section 20 declares that there is no statute of limitations on related civil causes of action.

The district court scrutinized this matrix of legislation in the context of the specificity test.[86] Both parties agreed that it was the correct rule to be utilized, although they disagreed as to the correctness of its application.[87] The lower court concluded that since the Yugoslavian right was not qualified by a limitation on the Yugoslavian remedy,[88] the statute of limitations of the forum should be enforced.

The district court offered three bases for its conclusion. First, the legislation directing that there was no statute of limitations for the criminal prosecution of war crimes, although specifically directed to criminal prosecutions, made no mention of civil actions.[89] The court acknowledged that there existed a statute of limitations which is specifically directed to another statute in the *Davis v. Mills* "sense." But the court observed that statute was Article 125 relating to criminal acts, not Section 1—the statute creating the civil cause of action which plaintiff sought to enforce.

Second, the district court observed that the statute of limitations (Section 20) was enacted seven years subsequent to the civil action created in Section 1[90] without any specific reference thereto. Because the statute of limitations was enacted after the statutory right, the court inferred that it was not the aim of the legislature to treat the substantive right as specifically and intentionally conditioned by the time provision.

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86 If the time limitation is directed to the statute creating the substantive right so specifically as to warrant saying that it qualifies the right, then the limitation will be considered part of the substantive law of the foreign jurisdiction and will be observed by the forum court. Davis v. Mills, 194 U.S. 451 (1904).

87 553 F.2d 549, 553 (7th Cir. 1977).

88 404 F.Supp. 57, 64 (N.D. Ill. 1975).

89 *Id.*

90 There is apparently a typographical error in the seventh sentence of the first incomplete paragraph in the right-hand column of 404 F.Supp. 57, 64. The sentence reads: "This statute of limitations was enacted seven years subsequent to the civil action created in Article 134(a) . . ." "Article 134(a)" should be omitted and replaced with "Section 1." Article 134(a) of the Criminal Code provides that there shall be no statute of limitations upon the prosecution of those accused of violations of Article 125. Section 1 provides a civil cause of action for those whose belongings were confiscated by the German occupation force.

The third argument used by the district court to support its conclusion that the foreign statute of limitations failed the specificity test is based on an evaluation of the nature of the statute itself. The court found the Yugoslavian limitations provision to be of a general nature, applicable to any civil action which accrues as the result of conduct that would subject the defendant to criminal prosecution.[91] The court concluded that *Davis v. Mills* required a limitation directive of a more specific nature than the broad statute present in the case before it.[92]

The Seventh Circuit, however, rejected the district court's analysis. It disagreed that the general statute of limitations precluded satisfaction of the specificity test and held instead that the limitations provisions of Yugoslavia were sufficiently part and parcel of the substance of the Yugoslavian statutory right.[93] As a result, the time limitation should be enforced as part of the substantive law of Yugoslavia. The longer statute of limitations would allow the plaintiff to enforce his claim. The court discussed three interpretive conclusions which led to its decision.

First, the court examined the relationship between Section 20 (the statute of limitations) and Article 134(a) (which imposed no time limitation on prosecutions of Article 125 criminal violations). The court concluded that the two statutes, when "read together, demonstrate a connection between the Yugoslavian provision that is adequately specific to warrant honoring the perpetual limitations in this case."[94]

Next, the appellate court addressed the fact that Section 20 must be applied through another statute, Article 134(a). The court asserted that this fact did not necessarily weaken the claim of specificity.[95] The court explained:

> Hypothetically, if Section 20 allowed the use of criminal limitations periods *only* in civil actions based on war crimes under Article 125, it is inconceivable that the reference to Article 134(a) that would be required to see what the criminal limitation was would flaw the otherwise obviously specific nature of Section 20.[96]

The third argument advanced by the Seventh Circuit in support of its decision dealt with the nature of Article 134(a). The court stated that when Article 134(a) was enacted, five specified war crimes (one of which was Article 125) became different from ordinary crimes since they were specifically exempted from criminal statutes of limitation. For that reason, concluded the court, civil causes of action *based* on the specified crimes became different from other crime-based causes of action.[97]

This third argument appears to embody the court's actual rationale for the decision in *Kalmich v. Bruno*. The first two reasons offered by the Seventh Circuit are far less substantive and subject to considerable criticism. The argument based on Article 134(a), on the other hand, involves a more realistic ap-

91 *Id.*
92 Davis v. Mills, 194 U.S. 451 (1904).
93 553 F.2d 549, 555 (7th Cir. 1977).
94 *Id.*
95 *Id.*
96 *Id.* (emphasis added).
97 *Id.*

proach to the problem and looks to the underlying policy of the law and legislative intent.

The first argument is based largely on interpretive readings of Yugoslavian law. The district court read Section 20 apart from Article 134(a)[98] and viewed Section 20 as a general statute of limitations that encompasses a wide variety of civil causes of action. In contrast, the Seventh Circuit read Section 20 and Article 134(a) together. This approach led the court to conclude that the legislation established a perpetual statute of limitations for five specified war crimes and any related civil causes of action.

This conclusion goes to the heart of the second reason the appellate court offered for its finding that the limitations provision was specifically addressed to the substantive law statute. The court asserted the claim of specificity was not weakened by the fact that Section 20 must be applied through another statute. The majority explained that there would be no difficulty in seeing the specific nature of Section 20 if it is assumed that the provision applies *only* to civil actions based on war crimes.[99] The actual language of the statutes, however, demonstrates that just the opposite is true: Section 20 allows the use of criminal limitations periods in *all* civil actions related to criminal conduct and not just those based on war crimes. As the dissent by Judge Swygert points out,[100] Section 20 applies to a broad range of cases unrelated to Section 1 or war crimes. Judge Swygert's dissent makes clear that the court's reasoning lacks credibility to the extent that it fails to recognize Section 20 as a general statute of limitations. Of course, had the court so characterized the statute, any application of the specificity test would have been precluded.[101] The dissent also makes clear that the district court properly applied the specificity test and followed its application through to its logical result. The lower court correctly characterized Section 20 as a general statute of limitations not specifically directed to the statutory right which Kalmich sought to enforce.[102] Statutory interpretation is stretched beyond its logical limits to reach a conclusion that the temporal provision "was directed to the newly created liability so specifically as to warrant saying that it qualified the right."[103] The Seventh Circuit, however, apparently had little difficulty in making this attenuated interpretation.

As stated earlier, the third major reason advanced by the court to explain its decision presents the strongest support for the result reached in *Kalmich v. Bruno*. The majority stated that when Article 134(a) was enacted, five specified war crimes, including Article 125, became "different" from ordinary crimes.

98 Section 20 is the civil suit statute of limitations which refers the court to the corresponding criminal action's limitation and Article 134(a) states that prosecution of certain war crimes will never be barred.

99 553 F.2d 549, 555 (7th Cir. 1977).

100 *Id.* at 556.

101 *See, e.g.*, U.S. v. Jacobs, 155 F.Supp. 182 (N.J. 1957). The dissent offers a hypothetical in which a plaintiff sues a defendant in Yugoslavia for damages resulting from plaintiff's conduct which constitutes arson under Yugoslavian law. Section 20 would direct the court to look to the criminal statute of limitations for the crime of arson. Following the majority's line of reasoning, an Illinois court would also be required to use the Yugoslavian statute of limitations for arson because the existence of a specified statute of limitations for that crime distinguishes it from other crimes. "The majority would consequently have the 'specificity' exception swallow the general rule." 553 F.2d 549, 556 (7th Cir. 1977).

102 404 F. Supp. 57, 64 (N.D. Ill. 1975).

103 Davis v. Mills, 194 U.S. 451, 454 (1904).

The court stated that the Yugoslavian legislature evidently intended to specifically condition the statutes authorizing the prosecution of these crimes by holding the transgressors perpetually liable for their conduct. To this extent, the court seems correct, for it is clear that the intent of the legislature was to avenge the crimes committed against the state by the enemy during the war. It may be assumed, therefore, that the legislature also intended private parties—the people against whom these crimes were committed—to be afforded the same opportunities to seek redress of wrongs committed against them. The law-making body recognized the close connection between civil causes of action based on criminal conduct and the criminal activity itself by enacting Section 20 which, in fact, made the statute of limitations the same for both categories.

The Seventh Circuit thus concluded that since the Yugoslavian legislature purposely gave special consideration to the law authorizing the prosecution of Nazi war criminals, the legislature implicitly gave the same special consideration to the related civil causes of action.

In reaching this result, it should be noted that the Seventh Circuit was confronted with a difficult situation, since a proper application of the specificity test would not yield a just result. The *Davis v. Mills* formula was intended to recognize statutorily created causes of action that had specific qualifying conditions so that the forum court could observe these conditions as part of the substantive law of the locus jurisdiction. In the *Kalmich* case, causes of action based on war crimes had a special condition attached—the foreign legislature determined that a perpetual statute of limitations would be the best policy. But the limitations provision of Section 20 lacked the specific reference to the statute creating the substantive right, and thus could not pass muster under *Davis*.[104] The specific time limitation imposed by Article 134(a) was necessarily determined through reference to a general statute of limitations which destroyed any sense of particularity.

One might hypothesize that the Seventh Circuit's solution to this dilemma ignored the result which would logically follow from a conventional interpretation of the test and found for the plaintiff notwithstanding the presence of a broadly-applicable statute of limitations that lacked any specific reference to the statute creating the substantive right. The court's laudable intention was to follow the directive of Justice Holmes that it "should recognize the full intent of that [foreign] legislature and enforce the statutory right with all its specific qualifications."[105]

In reaching this conclusion and allowing the plaintiff to press his claim, however, the court followed the spirit of the law at the expense of misconstruing or misinterpreting its letter.[106]

Statutes of Limitation as Substantive Law

In applying the specificity test, the Seventh Circuit overlooked a viable

104 *Id.*
105 *Id.*
106 It is not wholly accurate to refer to the "letter of the law" with regard to the specificity test for the simple reason that the test is a judicial invention and has not been codified into specific statutory language. For the purposes of discussion, however, this term best portrays the concept that is intended by the author.

alternative approach to the issue presented in *Kalmich v. Bruno*. The court's strained opinion incorporated some dubious reasoning in an attempt to achieve an outcome consonant with underlying policy considerations. It denied the clearly general character of the Yugoslavian Statute of Limitations and was therefore obliged to render an attenuated interpretation of the applicable statutes.

A more principled decision by the court could have been reached had it remanded the case to the district court with instructions to treat the statute of limitations as substantive law. The lower court would then have applied the Illinois choice of law rule—the significant relationship test—to the statute of limitations question.

The district court conceded that an application of the *Ingersoll* rule[107] could require a different result in this statute of limitations analysis.[108] But because the court found it to be "neither the best law nor the more reasonable rule,"[109] it declined to adopt this approach for a number of reasons.

First, the district court pointed out that in two of the decisions[110] which used the significant relationship approach, the objective was to achieve the result of a borrowing statute. These jurisdictions did not have borrowing statutes which would have instructed the court to enforce the shorter limitations period of the locus in order to discourage forum-shoppers. To accomplish this result, the courts in *Farrier* and *Heavner* justified application of the foreign statute of limitations (thus barring the suit), through the utilization of the Second Restatement approach. The court explained, "As Illinois has a borrowing statute the persuasiveness of these two cases is minimized."[111]

The district court's second rationale for rejecting the significant relationship test was the fact that the Ninth Circuit had itself, not long before, "implicitly" rejected the approach in *Klingebiel v. Lockheed Aircraft Corp.*[112]

The final reason that the district court offered for discarding the Second Restatement approach in the choice of statute of limitations analysis was that it "would jeopardize the measure of predictability of outcome guaranteed by the substantive procedural analysis."[113]

These reasons set forth by the lower court to support its conclusions in the case are less than wholly convincing. The initial discussion of the inapplicability of the significant relationship approach due to the presence of an Illinois borrowing statute misses the mark. That statute was not even at issue in this case. It has relevance only where, by the laws of a foreign jurisdiction, "an action thereon

107 In Ingersoll v. Klein, 46 Ill. 42, 262 N.E.2d 593 (1970), Illinois adopted the "most significant relationship" test wherein "the law of the place where the injury occurred should determine the rights and liabilities of the parties, unless Illinois has a more significant relationship with the parties in which case the law of Illinois should apply."

108 404 F.Supp. 57, 66 (N.D. Ill. 1975).

109 *Id.* 28 U.S.C. § 1332. A diversity court should adopt the best or more reasonable approach when ruling on novel state issues and may look beyond the forum state to prudently select the best law of other jurisdictions to govern state novel issues. Filley v. Kickoff Publishing Co., 454 F.2d 1288 (6th Cir. 1972); Gillam v. J.C. Penney Co., 341 F.2d 457 (7th Cir. 1965).

110 Farrier v. May Dept. Store Co., 357 F.Supp. 190 (D.D.C. 1973); Heavner v. Uniroyal Co., 63 N.J. 130, 305 A. 2d 412 (1973).

111 404 F.Supp. 57, 67 (N.D. Ill. 1975).

112 Klingebiel v. Lockheed Aircraft Corp., 494 F.2d 345 (9th Cir. 1974).

113 404 F.Supp. 57, 67 (N.D. Ill. 1975).

cannot be maintained by reason of the lapse of time."[114] In contrast, the laws of the foreign jurisdiction would have *allowed* the cause of action in the instant case rather than bar it.

Next, the court maintained that the Ninth Circuit's retreat in *Klingebeil* from the significant relationship approach "cautions this court in the formulation of Illinois policy."[115] But the *Klingebeil* court offered no substantive reasons for its decision, nor were any reasons advanced by the district court in its treatment of the instant case. *Klingebeil* seems to reflect little more than a preference of the Ninth Circuit to affirm the viability of the substance-procedure dichotomy,[116] and, as the district court's disposition of *Kalmich* demonstrates, there is little to be gained and much to be lost by unreasoned adherence to such a preference.

Finally, the district court's assertion that "predictability of outcome" would suffer with the adoption of the Second Restatement approach to statutes of limitation is probably the least convincing argument. The court's confidence in this aspect of the substantive-procedural rationale was certainly shattered when its decision was overturned by the appellate court. The traditional test's lack of predictability was vividly demonstrated by the higher court's reaching the opposite result when applying the same test to the same facts.[117]

These criticisms lead to a conclusion that has been sufficiently obvious to commentators on the law, and far too obscure to American courts: a treatment of statutes of limitation as substantive law would be the simplest solution to an unnecessarily complex problem. In significant relationship jurisdictions, the use of this approach to choice of limitations analysis would not only result in greater predictability, but would also effectively address the problem of forum shopping. The limitations period to be applied in any given case would not be in doubt, it would merely be that of the same jurisdiction from which the substantive law derives. The question of whether the *lex fori* rule, or one of its exceptions, should be applied would no longer be an issue. By the same token, forum shoppers would be frustrated in jurisdictions following the *lex loci delicti* rule because the limitations period of the jurisdiction where the cause of actions arose would accompany the suit and be applied regardless of the forum. Assuming that the primary goal in the conflict of laws is to establish a system in which the choice of a forum will not affect the result,[118] the foregoing discussion indicates that this goal would be best achieved by a significant relationship choice of limitations approach.[119]

Not only did the Seventh Circuit forego an opportunity to adopt the preferable significant relationship approach in *Kalmich & Bruno,* but through its

114 ILL. REV. STAT. ch. 83, § 21 (1973).
115 404 F.Supp. 57, 67 (N.D. Ill. 1975).
116 Klingebiel v. Lockheed Aircraft Corp., 494 F.2d 345, 347 (9th Cir. 1974).
117 Writers have argued that the substantive-procedural analysis suffers from an inadequate predictability factor. Comment, *Conflict of Laws,* 37 J. AIR L. & COM. 235 (1971); Comment, *Conflicts of Laws: Statutes of Limitation,* 29 OKLA. L. REV. 385 (1976).
118 3 BEALE, TREATISE ON THE CONFLICT OF LAWS (1935).
119 *See also* Guaranty Trust Co. v. York 326 U.S. 99 (1945), "(S)ince a federal court adjudicating a state-created right solely because of the diversity of citizenship of the parties is for that purpose, in effect, only another court of the State, it cannot afford recovery if the right to recover is made unavailable by the State nor can it substantially affect the enforcement of the right as given by the State." *Id.* at 108.

forced application of the specificity test the court set a dangerous precedent. It is not difficult to conceive of a similar fact pattern arising some time in the future: a cause of action barred by the forum statute of limitations but derived from a jurisdiction which has a longer general limitations provision, and, most importantly, strong equity considerations in favor of the plaintiff. That court may be tempted to point to this decision to justify its own application of a general statute of limitations to the specificity test. The Seventh Circuit's conclusion that a general statute of limitations "was directed to the newly created liability so specifically as to warrant saying that it qualified the right"[120] is nearly a contradiction in terms. Continued logic of this kind would eventually render the specificity test a nullity.

On the other hand, the practical effect of wider application of the significant relationship approach with regard to statutes of limitation would be to stress "the interests of the jurisdictions involved and [emphasize] a principle of realism in preference to an automatic test applied by a rule of thumb."[121]

Conclusion

The specificity test is intended as an objective means of determining legislative intent. The court must scrutinize (1) the language of the statute creating the substantive right, (2) the language of the limitations statute, and (3) the relationship between the statutes. It can thus determine whether there is a sufficient nexus to say that the limitation "qualifies the right"[122] and, as a result, that the limitation should be observed by the forum court. The decision reached by the Seventh Circuit in *Kalmich v. Bruno* would not have occurred had a proper application of the specificity test been made. Yet the result is consistent with the spirit of the law: civil causes of action related to war crimes are specially and specifically conditioned by a perpetual statute of limitations. The failings of the mechanical tests, like the specificity exception, force courts to misconstrue and improperly apply the rules of thumb in order to achieve equitable results. The treatment of statutes of limitation as substantive law would obviate many of these deficiencies, and would simultaneously address the problem of forum shopping. In addition, a greater predictability of outcome would be achieved. Finally the substantive law approach would provide an analysis that is judicially sound because of its basis in modern practical considerations rather than in the archaic logic of the substantive-procedural distinction.

Duane L. Tarnacki

120 Davis v. Mills, 194 U.S. 451 (1904).

121 Mack Trucks, Inc. v. Bendix-Westinghouse Auto. A.B. Co., 372 F.2d 18, 23 (3d Cir. 1966.)

122 Davis v. Mills, 194 U.S. 451 (1904).

III. Federal Procedure

CIVIL PROCEDURE—Disclosure of Grand Jury Transcripts—Standing to Challenge Disclosure of Grand Jury Transcripts In a Civil Action—Particularized Need Shown Where Factors Favoring Disclosure Outweigh Those Favoring Secrecy.

*Illinois v. Sarbaugh**

I. Introduction

Disclosure of grand jury transcripts is permissible only if the party who seeks disclosure shows a particularized need for the transcripts. In *Illinois v. Sarbaugh*, the United States Court of Appeals for the Seventh Circuit confronted three questions relating to this general proposition: (1) whether corporate defendants in a civil antitrust action had standing to oppose disclosure to the plaintiff of grand jury transcripts in the possession of the government; (2) whether an order by a federal district court denying disclosure of the transcripts was appealable; and (3) to what extent the particularized need standard applied in a civil antitrust action where the defendants had gained access to the transcripts in a prior criminal proceeding.

The Seventh Circuit answered the first two questions in the affirmative. It determined that the corporate defendants were the parties most likely to be adversely affected by any disclosure which the court might grant, and thus that they were entitled to be heard on the matter of disclosure even though they had already gained access to the transcripts. The Seventh Circuit also held that the district court's order denying disclosure to the plaintiffs was appealable.

In regard to particularized need, the Seventh Circuit held that particularized need is shown where the factors favoring disclosure outweigh those favoring secrecy. The court also allowed disclosure without requiring an *in camera* inspection of the transcripts by the trial judge, though certain restrictions were placed on how the transcripts could be used and to whom they could be shown. This method of dealing with the problem of disclosure of grand jury transcripts is the most liberal approach adopted by any circuit in granting disclosure, and it virtually assures the availability of grand jury transcripts to a plaintiff in an antitrust proceeding, though on a somewhat restricted basis.

II. Facts of the Case

Nine highway construction contractors and four of their officers were indicted in the United States District Court for the Eastern District of Illinois for violations of section 1 of the Sherman Act.[1] In the preparation of their defense, the corporate defendants, pursuant to Rule 16(a)(1)(A) of the Federal Rules

* 552 F.2d 768 (7th Cir. 1977), *cert. denied*, 46 U.S.L.W. 3238 (U.S. Oct. 11, 1977) (No. 76-1661).

1 15 U.S.C. § 1 (1970).

of Criminal Procedure,[2] obtained copies of testimony of their former and present employees before the grand jury. Rule 16(a)(1)(A) provides, *inter alia,* for disclosure to a corporate defendant of the grand jury testimony of any person who, at the time of his testimony before the grand jury, was "so situated as an officer or employee as to have been able legally to bind the [corporate] defendant in respect to conduct constituting the offense, . . ." Since the district court placed no restrictions on the use of the transcripts, each transcript was subsequently viewed by each defendant. The defendants eventually entered pleas of *nolo contendere.*

The state of Illinois then instituted civil antitrust proceedings in the United States District Court for the Southern District of Illinois against these defendants and five additional highway contractors. The violations alleged in the civil suit were the same as those involved in the criminal proceeding. As part of discovery, the state petitioned the southern Illinois district court, pursuant to Rule 6(e) of the Federal Rules of Criminal Procedure,[3] to order John E. Sarbaugh, Chief of the Antitrust Division's Midwest Office, to turn over to the state the same grand jury transcripts disclosed in the prior criminal action. Rule 6(e) controls disclosure of grand jury transcripts in all judicial proceedings, civil or criminal. The southern Illinois district court held that it lacked the power to issue the order because the transcripts sought related to grand jury proceedings in another district (*i.e.,* eastern Illinois). Furthermore, the court ruled that it lacked jurisdiction to compel the corporate defendants to disclose the transcripts in their possession. The state had also petitioned for this alternative means of disclosure.

The state then petitioned the eastern Illinois district court for the same order, to which respondent Sarbaugh raised no objection. Notice of the petition was also sent to the corporate defendants, and upon their objection to disclosure, a hearing was held. At the hearing, the state raised no objection to the appearance of the defendants. The court, after hearing argument, ruled that the state had not made the showing of particularized need required for disclosure. The court recognized, however, that the requisite need could arise at trial in the southern Illinois district court and therefore ordered the transfer of the transcripts for disclosure at such a time.[4]

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2 FED. R. CIV. P. 16(a)(1)(A) provides in pertinent part:
> Where the defendant is a corporation . . . the court may grant the defendant, upon its motion, discovery of relevant recorded testimony of any witness before a grand jury who (1) was, at the time of his testimony, so situated as an officer or employee as to have been able legally to bind the defendant in respect to conduct constituting the offense, or (2) was, at the time of the offense, personally involved in the alleged conduct constituting the offense and so situated as an officer or employee as to have been able legally to bind the defendant in respect to that alleged conduct in which he was involved.

3 FED. R. CRIM. P. 6(e) provides:
> Disclosure of matters occurring before the grand jury other than its deliberations and the vote of any juror may be made to the attorneys for the government for use in the performance of their duties. Otherwise a juror, attorney, interpreter or stenographer may disclose matters occurring before the grand jury only when so directed by the court preliminarily to or in connection with a judicial proceeding or when permitted by the court at the request of the defendant upon a showing that grounds may exist for a motion to dismiss the indictment because of matters occurring before the grand jury. . . .

4 The eastern Illinois district court said:
> The Court believes that it would be entirely proper for petitioner to move for

The state appealed to the Seventh Circuit from the eastern Illinois district court's denial of disclosure, and the corporate defendants, as intervenors and appellees, sought to have the appeal dismissed. The state challenged their intervention.

III. Standing

A. *The Seventh Circuit's Position in* Sarbaugh

The first issue that confronted the Seventh Circuit in *Sarbaugh* was whether the corporate defendants had standing to oppose disclosure of the grand jury transcripts to the state of Illinois. The court did not frame the issue in this manner, however, but instead approached the problem as one involving the right of the corporate defendants to intervene in the district court. Because it framed the issue in this manner, the bulk of the Seventh Circuit's reasoning is dictum, for the court found that the intervention question could be decided on the basis of waiver.[5] Nevertheless, it is clear from the court's argument that it meant to address the issue of standing. The court intimated this in its conclusion that the defendants had "an interest sufficient to satisfy the requirement of standing"[6] and were thus entitled to intervene.

Thus, although ostensibly faced with the problem of whether the corporate defendants had a right to intervene in the proceedings in the eastern Illinois district court, the real issue involved in *Sarbaugh* was one of standing. This distinction is crucial, for if the defendants lacked standing to challenge disclosure, the Seventh Circuit would have been compelled to dismiss their intervention despite the waiver. If, on the other hand, the defendants had standing, their right to intervene would have been established, for Rule 24(a)(2) of the Federal Rules of Civil Procedure states that the right to intervene exists when "the applicant claims an interest relating to the . . . transaction which is the subject of the action" and the party is so situated that disposition of the action may ad-

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production of the requested transcripts at the time of the trial of the civil suit to use for purposes of impeachment, refreshing recollection and challenging credibility of those witnesses who had previously testified before the grand jury. At that time petitioner would be in a position to establish compelling need, for example, by pointing to a failure of memory on the part of a witness, a showing of contradiction between the testimony and reliable documentary evidence or perhaps by prevailing upon the trial court for an *in camera* examination of the transcripts to uncover any inconsistencies.

552 F.2d at 771 n.1.

5 The state of Illinois challenged the appearance of the defendants on appeal on the ground that they had failed to comply with FED. R. CIV. P. 24(c), when they made their initial appearance in the eastern Illinois district court to challenge disclosure. Basically, Rule 24(c) requires that a party who seeks to intervene must serve a motion to intervene upon the parties. The motion must state the grounds for intervention and must be accompanied by a pleading that states the claim or defense for which intervention is sought. The defendants had failed to comply with this procedure.

The Seventh Circuit answered this contention by pointing out that the state had waived any right to challenge the intervention of the defendants by failing to make this objection upon their initial appearance at the hearing in the eastern Illinois district court. 552 F.2d at 772. *See, e.g.*, Klein v. Nu-Way Shoe Co., 136 F.2d 986 (2d Cir. 1943); Simms v. Andrews, 118 F.2d 803 (10th Cir. 1941).

6 552 F.2d at 773.

versely affect his ability to protect his interest.[7] A party who has standing automatically falls within this provision.

Therefore, the first question that confronted the Seventh Circuit was whether the corporate defendants had a sufficient interest in the secrecy of the transcripts to make them the proper parties to oppose disclosure. The court found that the defendants did have a sufficient interest to give them standing and thus to bring them within the purview of Rule 24(a)(2) of the Federal Rules of Civil Procedure.

1. Previous Case Law

The court began its analysis by examining its previous decisions on the issue of standing to challenge disclosure of grand jury transcripts. The Seventh Circuit found that it had never before directly confronted the issue presented in *Sarbaugh*. The court had, however, heard objections to disclosure by witnesses who had testified before the grand jury. The court reasoned that since it had heard these cases on the merits, the witnesses must have had standing to oppose disclosure.

The cases to which the court referred were *In re Special February 1971 Grand Jury v. Conlisk*[8] and *In re Holovachka.*[9] In *Conlisk,* the Seventh Circuit denied the motion of five police officers who objected to disclosure of their grand jury testimony to a police investigatory board. In *Holovachka,* a grand jury witness challenged disclosure of his testimony to the Attorney General of Indiana in connection with disbarment proceedings. The Seventh Circuit concluded that since it had heard the appeals in these cases, the witnesses must have had standing to challenge disclosure.

The Seventh Circuit failed to establish the relevance of these two cases to *Sarbaugh*. Simply because the Seventh Circuit heard the appeals in these cases did not in any way imply that the corporate defendants in *Sarbaugh* had standing to challenge disclosure. Both *Conlisk* and *Holovachka* involved challenges by grand jury witnesses to the disclosure of *their own* testimony. The interest of a grand jury witness in the secrecy of his testimony has always been recognized by the courts.[10] The corporate defendants in *Sarbaugh,* however, were not grand jury witnesses. Further, protection of an indicted party has never been recognized as an interest which merits the secrecy of grand jury testimony.

The Seventh Circuit did attempt to answer this objection. The court read Rule 16(a)(1)(A)[11] to imply that when certain employees of a corporation testify before a grand jury, their testimony is in fact the testimony of the corpo-

7 FED. R. CIV. P. 24(a)(2), provides:
Upon timely application anyone shall be permitted to intervene in an action: . . . ; (2) when the applicant claims an interest relating to the property or transaction which is the subject of the action and he is so situated that the disposition of the action may as a practical matter impair or impede his ability to protect that interest, unless the applicant's interest is adequately represented by existing parties.

8 490 F.2d 894 (7th Cir. 1973).

9 317 F.2d 834 (7th Cir. 1963).

10 *See, e.g.,* Pittsburgh Plate Glass Co. v. United States, 360 U.S. 395, 400 (1959); United States v. Rose, 215 F.2d 617, 628-29 (3rd Cir. 1954); United States v. Amazon Industrial Chemical Corp., 55 F.2d 254, 261 (D.C. Md. 1931).

11 *See* note 2 *supra.*

ration.[12] The court implied that in such a case the witnesses are the agents of the corporation at the time of their testimony.

A careful examination of the rule reveals that the court's analysis is unwarranted. The rule makes a distinction between the corporate employee who testifies before the grand jury and the corporate defendant.[13] Moreover, this distinction is clearly consistent with the policies behind grand jury secrecy. Protection of grand jury witnesses from retaliation has always been recognized by the courts as a reason for maintaining the secrecy of grand jury testimony. As a practical matter, it is the corporate defendant from whom the grand jury witness must be protected, for it is the corporate defendant who is most likely to retaliate against an employee for any adverse testimony.[14] To hold that the employee acts for the corporation in giving his testimony before the grand jury contradicts this established policy for maintaining grand jury secrecy. Thus, it is clear that the Seventh Circuit had no support in its previous case law for granting the defendants standing to oppose disclosure of the grand jury testimony.

2. Other Reasons

In addition to citing previous case law, the Seventh Circuit developed a specific rationale for its holding that the corporate defendants had standing and were thus entitled to intervene in the disclosure proceedings.

a. *Fed. R. Crim. P. 6(e)*

The court began by examining Rule 6(e) of the Federal Rules of Criminal Procedure.[15] Rule 6(e) provides that a person "may disclose matters occurring before the grand jury only when so directed by the court preliminarily to or in connection with a judicial proceeding. . . ." The Seventh Circuit noted that the rule fails to mention specifically who has a right to object to disclosure.[16] The court adopted the reasoning urged by the government, however, and stated that since the rule contemplates a judicial proceeding of some kind, and since such proceedings are not usually *ex parte*, a proper interpretation of the rule in this case was that the corporate defendants were the only suitable parties to object to disclosure.[17] The Seventh Circuit inferred that the government was not likely to object to a motion for disclosure and argued that if the corporate defendants were not allowed to object to disclosure, only the form of an adversary proceeding would have remained.[18] In essence, the Seventh Circuit concluded that Rule 6(e) implicitly recognized that corporate defendants have standing to oppose disclosure of grand jury transcripts.

12 552 F.2d at 772 n.4.
13 The rule makes a clear distinction between a "witness" before the grand jury and the "defendant." It seems that if the rule meant to allow disclosure to the corporate defendant of the testimony given by an *agent* of the defendant, appropriate language would have been employed.
14 *See* text accompanying note 61 *infra.*
15 *See* note 3 *supra.*
16 552 F.2d at 773.
17 *Id.*
18 *Id.*

Although Rule 6(e) does seem to contemplate an adversary proceeding of some sort, it is not clear that this necessarily means that the rule contemplates the presence of parties in the position of the corporate defendants in the instant case. It is at least arguable that the government is fully capable of providing the adversary element referred to since it has a recognizable interest in assuring that future grand jury witnesses will not withhold testimony for fear of having it released at a later date. Thus, it is conceivable that the government would oppose disclosure to a plaintiff in a civil action if it believed that disclosure would have a chilling effect on future grand jury witnesses. Thus, simply because the government had no objection to disclosure in *Sarbaugh* does not mean that it may not serve as an adversary within the purview of Rule 6(e). Rule 6(e) therefore is not adequate authority for the Seventh Circuit's holding that the corporate defendants in *Sarbaugh* had a sufficient interest in the disclosure proceedings to warrant standing.

b. *Fed. R. Civ. P. 24 (a)(2)*

The court next referred to Rule 24(a)(2) of the Federal Rules of Civil Procedure,[19] which deals specifically with the question of who has the right to intervene in a particular civil controversy.

To bring the corporate defendants within this rule, the Seventh Circuit had to find (1) that the corporate defendants claimed an interest in the matter of disclosure; (2) that granting disclosure would, as a practical matter, have impaired or impeded their ability to protect that interest; and (3) that the interest was not adequately represented by the existing parties.

In attempting to fit the corporate defendants into the requirements of this rule, the court began by admitting that the reasons for maintaining grand jury secrecy do not include the protection of indicted parties.[20] Nevertheless, the court stated that as a practical matter the corporate defendants were "among those who would be adversely affected by disclosure of the information, and therefore should have a right to be heard."[21] The court's reasoning went no further than this.

The basic flaw in the court's attempt to fit the corporate defendants into Rule 24(a)(2) was its failure to identify the interest of the defendants that would have been adversely affected by allowing disclosure to the state. If the defendants had no legitimate interest in the controversy before the court, it is difficult to see how they would have been adversely affected by any ruling the court could have made. Because the Seventh Circuit failed to make explicit the interest of the corporate defendants in maintaining grand jury secrecy, it is not clear how Rule 24(a)(2) applies to the defendants in *Sarbaugh*.

c. *The Issue Involved*

The Seventh Circuit concluded its discussion of the standing issue by stating

19 *See* note 7 *supra*.
20 552 F.2d at 773. *See also* Pittsburgh Plate Glass Co. v. United States, 360 U.S. 395, 400 (1959); United States v. Procter & Gamble, 356 U.S. 677, 681-82 n.6 (1958).
21 552 F.2d at 773.

that since the defendants had standing to *seek* disclosure in the prior criminal proceedings, they should have standing to *oppose* disclosure in the civil action. The court asserted that essentially the same issue is involved in either case.[22]

Although the court did not discuss this point, its conclusion was clearly erroneous. There are separate issues and interests at stake where disclosure is sought and where it is opposed. A party who seeks disclosure of grand jury transcripts has an identifiable interest in assuring himself that the truth-finding function of the trial is served. Grand jury transcripts are a tool which can be used by that party to ascertain whether the testimony given by an adverse witness at trial is consistent with prior testimony. This interest has been readily accepted by the courts.[23]

When a party opposes disclosure, however, the basic interest involved is one of secrecy. Policy considerations other than assuring the truth-finding function of the trial assume primary importance.[24] The protection of an indicted person, as previously mentioned, has never been recognized as one of these policies supporting grand jury secrecy.[25] In addition, at least one lower court decision has held that where a party has obtained a waiver of grand jury secrecy for his own purposes, he cannot thereafter assert secrecy as a bar to further disclosure.[26] Since the corporate defendants in *Sarbaugh* could not claim an interest in maintaining the secrecy of the grand jury testimony on the basis of their status as indicted persons, and since they had previously obtained a waiver of grand jury secrecy for their own purposes, it is clear that they had no identifiable interest in secrecy sufficient to give them standing to intervene in the disclosure proceedings in the district court.

It is therefore apparent that disclosure and secrecy involve separate issues. Although a party may have an interest in one or the other, it does not follow that the same party has an interest in both. The reasoning used by the Seventh Circuit failed to recognize this basic distinction.

B. *Approaches of the Third Circuit and the Northern Illinois District Court*

In holding that the corporate defendants had standing and were entitled to intervene in the disclosure proceeding in the eastern Illinois district court, the Seventh Circuit diverged from prior decisions of the Third Circuit and the District Court for the Northern District of Illinois.

In *United States v. American Oil Co.*,[27] the Third Circuit directly confronted the standing issue. In this case, the government had initiated criminal proceedings in the New Jersey district court. The defendants had obtained disclosure of pertinent portions of grand jury testimony during this proceeding. At

22 The court stated that "[t]he right of the defendants in the criminal case to be heard *on the issue of disclosure* should be the same in either the civil or criminal proceeding." *Id.* (emphasis added). Although the court's statement is undoubtedly correct where the defendant seeks disclosure, it is inapplicable where disclosure is opposed.

23 *See* text accompanying note 55 *infra.*

24 *See* text accompanying notes 52-54 *infra.*

25 *See* text accompanying note 10 *supra.*

26 *See* Connecticut v. General Motors Corp. [1974], 2 TRADE CASES (CCH) ¶ 75, 138 (N.D. Ill. 1974), discussed in the text accompanying notes 28-30 *infra.*

27 456 F.2d 1043 (3rd Cir. 1972) (per curiam).

the conclusion of the criminal prosecution, the government began civil proceedings against the same defendants. Concurrently with the initiation of the civil suit by the government, a private plaintiff began a private civil antitrust action against the defendants. Before a final decree was entered in the government's civil case, the private plaintiff sought to intervene in order to obtain from the government the transcripts that had been revealed to the defendants in the criminal action. The district court granted disclosure over the objection of the defendants.

The Third Circuit upheld the decision of the lower court on the ground that the defendants lacked standing to challenge disclosure. The court pointed out that the grand jury proceedings had terminated,[28] that final judgment had been granted in the criminal case,[29] and that the order to produce was directed to the government and not to the defendants.[30] For these reasons, the court maintained that it had little doubt that the defendants lacked standing to challenge disclosure.

The Third Circuit did not provide any argument in support of its holding. It simply listed the aforementioned factors and assumed that the answer to the standing question was self-evident. Thus, it is difficult to determine how the Seventh Circuit's reasoning in *Sarbaugh* differed from that used by the Third Circuit in *American Oil Co.* Whatever the rationale used by the Third Circuit, however, it is clear that the factors cited by that court as precluding the standing of the corporate defendants were also present in *Sarbaugh*. If one assumes, as the Third Circuit seems to have done, that these factors represent the only areas where a corporate defendant could possibly have an interest in maintaining grand jury secrecy, it is clear that the defendants in *Sarbaugh* should have been denied standing. Given the weakness of the arguments used by the *Sarbaugh* court to support its holding on the standing issue, the Third Circuit's approach seems preferable.

In addition to differing with the Third Circuit on the standing issue, the Seventh Circuit implicitly overruled a previous decision of the District Court for the Northern District of Illinois. In *Connecticut v. General Motors Corp.*,[31] a private plaintiff in a multi-district antitrust action had petitioned the northern Illinois district court for an order to require the defendants to disclose transcripts already in their possession. The defendants opposed disclosure.

The court in *General Motors* ruled that even though the government no longer possessed the transcripts in question and disclosure was sought directly from the defendants, the only party empowered to assert grand jury secrecy as a defense to disclosure was the United States Attorney, as an agent of the government, who had obtained the testimony during prior criminal proceedings.[32] The court stated that any secrecy that attached to the grand jury transcripts had been abrogated by the prior disclosure to the defendants and that any interest in secrecy which the defendants had could be adequately protected by the usual rules of discovery.[33]

28 *Id.* at 1044.
29 *Id.*
30 *Id.*
31 [1974] 2 TRADE CASES (CCH) ¶ 75,138 (N.D. Ill. 1974).
32 *Id.* at 97,081.
33 *Id.* at 97,080.

Although the plaintiff sought disclosure directly from the defendants in *General Motors*, it is clear that if the defendants were not entitled to interpose the defense of grand jury secrecy in that case, they would undoubtedly have lacked standing to oppose disclosure if it had been sought from the government. The Seventh Circuit in *Sarbaugh* made no attempt to address this case in its discussion of the standing issue.

C. *Summary and Critique*

The Seventh Circuit in *Sarbaugh* provided inadequate support for its holding that the corporate defendants had standing to challenge disclosure. Although the court claimed that the defendants possessed a sufficient interest in maintaining the secrecy of the grand jury testimony to warrant standing, the court never intimated the nature of this interest. If one examines the position of the defendants in *Sarbaugh* in light of the factors used by the Third Circuit in *American Oil Co.*, the absence of a legitimate interest is clear.

Since the grand jury proceeding had terminated, the corporate defendants had no interest in protecting their reputation from possible harm in case an indictment was not returned. Since a final judgment had been granted in the criminal case, the defendants' case could not be prejudiced in any way by disclosure. Finally, since the order to produce was directed to the government and not to the defendants, any possible interest the defendants may have had became even more tenuous. This becomes clearer in light of the *General Motors* decision, which held that a corporate defendant may not assert grand jury secrecy as a bar to disclosure if that corporate defendant has gained access to grand jury transcripts in a prior criminal proceeding. This holds true even if disclosure is sought directly from the defendant.

None of the arguments advanced by the Seventh Circuit reveal adequate grounds for granting standing to the corporate defendants. The protection of an indicted party has never been recognized by previous case law as an interest meriting the secrecy of grand jury testimony. Although the Seventh Circuit attempted to avoid this problem in several ways, it never established the nature of the interest involved. Given the nature of the Seventh Circuit's analysis, it seems clear that the reasoning of the Third Circuit and the northern Illinois district court is stronger. Standing should have been denied the defendants in *Sarbaugh*.

IV. Appealability

After deciding that the corporate defendants were entitled to intervene, the Seventh Circuit had to decide whether the order of the eastern Illinois district court denying disclosure of the transcripts was a final order within the meaning of 28 U.S.C. § 1291.[34] Section 1291 grants the courts of appeals jurisdiction of a

34 28 U.S.C. § 1291 (1970) provides:
> The courts of appeals shall have jurisdiction from all final decisions of the district courts of the United States, the United States District Court for the District of the Canal Zone, the District of Guam, and the District Court of the Virgin Islands, except where a direct review may be had in the Supreme Court.

controversy only if a final order or decision has been rendered in the appropriate district court. The Seventh Circuit decided that the denial of disclosure was a final order and that the court thus had jurisdiction to hear the merits of the state's appeal.

In examining this issue, the court first reasserted that Rule 6(e) of the Federal Rules of Criminal Procedure vested jurisdiction over the grand jury transcripts in the eastern Illinois district court, for it was in this district that the grand jury had been convened. The Seventh Circuit then had to determine whether the order denying disclosure in the Eastern District was in some way dependent on the proceedings in the Southern District, which would have made the order interlocutory, or whether it arose out of completely independent proceedings. The Seventh Circuit concluded that the disclosure proceedings in the Eastern District were independent of the civil proceedings in the Southern District, thus making the order denying disclosure final.[35]

The court quoted from *United States v. Byoir*[36] in determining that the eastern Illinois district court's order "dispose[d] of the contentions of all the parties, leaving nothing else to be decided."[37] In *Byoir,* the defendant was indicted in the District Court for the Northern District of Texas. The case was dismissed, but proceedings based on the same facts were instituted in the District Court for the Eastern District of Illinois, and the government used evidence presented before the Texas grand jury as part of its case. The defendant was arrested in New York pursuant to the latter proceedings and resisted removal to Illinois for trial. As part of the removal proceedings, the New York judge postponed the removal hearing to allow the defendant to petition the northern Texas district court for disclosure of the relevant grand jury transcripts. The Texas court ordered disclosure, and the government appealed. On appeal, the Fifth Circuit held that the order granting disclosure was final, since there was no pending prosecution in the northern Texas district court, the jurisdiction exercised by the court involved the right of the court to control its officers and records, and no further trial was pending in the court.[38]

These same factors were present in *Sarbaugh.* There was no pending prosecution in the eastern Illinois district court, the jurisdiction exercised involved the control of the court over its officers and records, and no trial was pending.

The Second Circuit, in *Baker v. United States Steel Corp.,*[39] confronted a similar situation, but it held the order of the lower court nonappealable. The Seventh Circuit therefore felt understandably obliged to distinguish *Sarbaugh* from *Baker.* In *Baker,* an indictment had been returned against corporate defendants in an antitrust suit in the District Court for the Southern District of New York. The defendants subsequently entered pleas of *nolo contendere.* A private civil antitrust suit was then initiated in the Connecticut district court. As part of discovery, the plaintiffs in the private action sought the grand jury transcripts of the testimony of seven witnesses who were deceased at the time the civil proceed-

35 552 F.2d at 773.
36 147 F.2d 336 (5th Cir. 1947).
37 147 F.2d at 337, *quoted in* 552 F.2d at 773.
38 147 F.2d at 337.
39 492 F.2d 1074 (2d Cir. 1974).

ings were commenced. The judge of the Connecticut court certified to the southern New York district court his need for the transcripts and requested that they be sent to the Connecticut court. The defendants obtained a hearing in the New York court on whether the court should grant the Connecticut court's request and transfer the transcripts. After the hearing, the court ordered transfer of the transcripts for "reasons of judicial administration."[40] The defendants sought to appeal this order.

The Second Circuit found the order nonappealable. It held that discovery orders were interlocutory (1) when they were issued in the same jurisdiction as the pending proceeding, or (2) when another jurisdiction granted disclosure.[41] The court went on, in dictum, to state that if it had been dealing "with an order of a different district *denying* access to the transcripts," the order would have been reviewable.[42]

Although the Second Circuit, judging from its dictum, would apparently have held the order in *Sarbaugh* appealable, the Seventh Circuit pointed out that "the rationale of the Second Circuit does not appear to be in harmony with the view we have adopted."[43] This proposition appears warranted even though *Baker* and *Sarbaugh* are distinguishable on their facts.[44]

In *Baker,* the southern New York district court ordered the transfer of the transcripts upon the request of the Connecticut district court. In *Sarbaugh,* on the other hand, the Eastern Illinois district court ordered the transfer of the transcripts to the Southern Illinois district court after making an independent examination of the situation. No request was issued by the Southern Illinois district court for the transcripts, and as a result the independence of the two proceedings seems clear.

The fact remains, however, that the dictum in *Baker* and the holding in *Sarbaugh* are irreconcilable despite the factual distinctions. The Seventh Circuit would apparently hear an appeal whenever there was no pending prosecution in the court issuing the order, the jurisdiction exercised by the court involved the right of the court to control its officers and records, and no further trial was pending in that district. The Second Circuit, on the other hand, would not hear an appeal whenever disclosure was granted, whether this disclosure occurred in the district where the trial was pending or in another district.

The Seventh Circuit position is preferable. Even if the eastern Illinois district court in *Sarbaugh* had granted disclosure, the independence of those proceedings from the civil action in the southern Illinois district court was unquestionable. A showing was made by the state of Illinois independently of any previous proceedings in the southern Illinois district court. To hold that an appeal could not be obtained from an order granting disclosure totally ignores the nature of the proceedings in the Eastern District. Thus, the Seventh Circuit, in granting the appeal, correctly decided the issue.

40 *Id.* at 1076.
41 *Id.* at 1077.
42 *Id.* at 1078.
43 552 F.2d at 774 n.7.
44 *Id.*

V. Grand Jury Disclosure

After deciding that the order of the Eastern District was appealable, the Seventh Circuit confronted the merits of the case. The basic question before the court was whether the judge, in refusing disclosure to the state, had properly exercised his discretion. The Seventh Circuit held that the judge of the eastern Illinois district court had exercised his discretion improperly, since the state, given the totality of circumstances, had shown a sufficient need for disclosure to allow the court to grant limited access. To place this holding in its proper context, it is necessary to view *Sarbaugh* in historical perspective.

A. *Particularized Need: Standard and Policy*

The basic framework used by the courts in dealing with disclosure of grand jury transcripts was first outlined by the Supreme Court in *United States v. Procter & Gamble*[45] and *Pittsburgh Plate Glass Co. v. United States.*[46] In these landmark cases the Court established that the trial judge, in exercising his discretion to disclose grand jury transcripts, must find a "particularized need" for the transcripts on the part of the party seeking disclosure.[47]

In *Procter & Gamble,* the defendants in a civil antitrust suit sought disclosure of transcripts obtained by the government from a grand jury that had failed to return an indictment. Since civil litigation was involved, the defendants sought disclosure of the transcripts pursuant to Rule 34 of the Federal Rules of Civil Procedure.[48] The Supreme Court concluded that although the relevancy of the transcripts to the defendants' case was undeniable, they had failed to show that "without the transcripts a defense would be greatly prejudiced or that without reference to it an injustice would be done."[49] The Court went on to state that grand jury secrecy would only be breached "where there is a compelling necessity."[50] The Court concluded that although discovery serves a useful purpose in litigation, it does not outweigh the strong policy considerations in favor of grand jury secrecy.[51]

The policy considerations referred to by the Court as supporting grand jury

45 356 U.S. 677 (1958).
46 360 U.S. 395 (1959).
47 This standard applies whenever grand jury transcripts are sought by a party for use in connection with a judicial proceeding, whether criminal or civil. Furthermore, it makes little difference if disclosure is sought under Rule 6(e) or Rule 34, FED. R. CIV. P. *See* Pittsburgh Plate Glass Co. v. United States, 360 U.S. 395 (1959); United States v. Procter & Gamble, 356 U.S. 677 (1958).
48 FED. R. CIV. P. 34, at the time of *Procter & Gamble* provided in part:

> Upon motion of any party showing good cause therefor and upon notice to all other parties, and subject to the provisions of Rule 30(b), the court in which an action is pending may (1) order any party to produce and permit the inspection and copying or photographing, by or on behalf of the moving party of any designated documents, . . . not privileged, which constitute or contain evidence relating to any of the matters within the scope of the examination permitted by Rule 26(b) and which are in his possession, custody, or control. . . .

In 1970, the rule was amended to eliminate the requirement that the moving party show "good cause" for disclosure.
49 356 U.S. at 682.
50 *Id.*
51 *Id.* at 682-83.

secrecy were first outlined in *United States v. Amazon Industrial Chemical Corporation,*[52] and later in *United States v. Rose.*[53] The *Rose* court noted the following considerations: (1) to prevent the escape of the person being considered for indictment; (2) to insure the utmost freedom in grand jury deliberations; (3) to prevent any tampering with the witnesses; (4) to encourage witnesses to speak freely before the grand jury without fear that their testimony would be made public and thereby subject them to possible retaliation; and (5) to protect the innocent accused in the event that an indictment is not returned.[54] The *Rose* court stated that before disclosure could be granted, the party seeking disclosure must demonstrate a need that outweighed these policy factors. In dictum, the Supreme Court in *Procter & Gamble* suggested that the "use of the grand jury transcript at the trial to impeach a witness, to refresh his recollection, to test his credibility, and the like" were cases of particularized need which would allow the trial judge to lift the veil of secrecy "discretely and limitedly."[55]

In *Pittsburgh Plate Glass Co.,* the second important Supreme Court case to deal with the standards applicable to the disclosure of grand jury transcripts, the Court determined that a defendant in a criminal proceeding does not have a "right" to grand jury transcripts. The defendants had claimed, after an important government witness had testified at trial, that they had a right to his grand jury transcripts. The Court ruled that they did not have such a right, that disclosure of the transcripts was a matter totally within the discretion of the trial judge, and that the defendants had failed to show a particularized need for the transcripts. The Court indicated, however, that its decision might have been different had the defendants appealed to the discretion of the trial judge. Indeed, the Court in *Procter & Gamble* stated that impeachment of a witness was a case of particularized need. By failing to appeal to the discretion of the trial judge, the defendants in *Pittsburgh Plate Glass* failed to meet the standard of particularized need required for disclosure.

In *Procter & Gamble* and *Pittsburgh Plate Glass,* the Supreme Court established that disclosure of grand jury transcripts is totally within the discretion of the trial judge. Furthermore, the Court stated that the burden is on the party who seeks disclosure to show a particularized need for the transcripts which outweighs the policy considerations in favor of secrecy.

It is important to note with regard to the strong policy of grand jury secrecy that in both *Procter & Gamble* and *Pittsburgh Plate Glass* the Supreme Court placed special emphasis on the fact that grand jury secrecy would "encourage all witnesses to step forward and testify freely without fear of retaliation."[56] The Court failed to point out, however, that once a trial begins, the protection of grand jury witnesses from retaliation is the *only* reason that remains for maintaining grand jury secrecy. This point is of special significance in *Sarbaugh,* for the Seventh Circuit was confronted with a case where even this consideration was absent. Thus, the court in *Sarbaugh* was called on to determine the effect this had

52 55 F.2d 254 (D.C.Md. 1931).
53 215 F.2d 617 (3d Cir. 1954).
54 *Id.* at 628-29.
55 356 U.S. at 683.
56 356 U.S. at 682.

on the level of need required before disclosure could be granted.

B. *The Seventh Circuit Approach*

1. Balancing Test

In *Procter & Gamble* and *Pittsburgh Plate Glass,* the Supreme Court analyzed the particularized need which a *defendant* had to show in order to gain disclosure of grand jury transcripts. In *Sarbaugh,* the Seventh Circuit was confronted with the problem of determining the requisite need where a *plaintiff* in a civil action sought disclosure of transcripts already revealed to the defendants in a prior criminal action.

In *U.S. Industries v. United States District Court,*[57] the Ninth Circuit confronted a similar problem. The plaintiff in a civil antitrust action sought disclosure of a presentence memorandum that contained parts of grand jury testimony. The corporate defendants had gained access to the memorandum in the prior criminal proceedings. The trial court granted disclosure. The Ninth Circuit, after ruling that such a memorandum did fall within Rule 6(e), upheld the disclosure. The court ruled that although the plaintiff would have to show a particularized need in order to gain disclosure, the level of need required would decrease as the reasons for secrecy became less compelling.[58]

After it had determined that the particularized need standard was not an absolute, the Ninth Circuit proceeded to perform the balancing test. It found that the only possible reasons for maintaining secrecy in the case before it were to protect grand jury witnesses against retaliation and to insure untrammelled disclosure of information by future grand jury witnesses.[59] The court reasoned that since the corporate defendants had already gained access to the memorandum, denial of disclosure could no longer further the goal of protecting the witnesses whose testimony was contained therein against retaliation by the defendants. As to future witnesses, the court ruled that their interest could be protected by having the trial judge, in an *in camera* inspection of the memorandum, delete any material which could possibly have a bearing on such testimony.

A year later, the Supreme Court ruled in *Dennis v. United States*[60] that a criminal defendant had shown particularized need for a grand jury transcript where minimal reasons for secrecy existed and the transcripts contained the testimony of key government witnesses. The Court recognized that the level of particularized need may vary with the strength of the policy considerations for maintaining secrecy and thus implicitly affirmed *U.S. Industries.*

The court in *Sarbaugh,* relying on *U.S. Industries, Dennis,* and two lower court decisions within the Seventh Circuit,[61] proceeded to perform the balancing test. The court held that since the corporate defendants had obtained disclosure pursuant to Rule 16(a)(1)(A), minimal reasons for secrecy remained. The

57 345 F.2d 18 (9th Cir. 1965).
58 *Id.* at 21.
59 *Id.* at 22.
60 384 U.S. 855 (1966).
61 In re Cement-Concrete Block, Chicago Area, 381 F.Supp. 1108 (N.D. Ill. 1974); Illinois v. Harper & Row Publishers, Inc., 50 F.R.D. 37 (N.D. Ill. 1969).

court recognized that any retaliation against the witnesses was likely to come from the corporate defendants themselves. Furthermore, the court noted that since no restrictions had been placed on the defendants' use of the transcripts, and the transcripts had been circulated among all the defendants, the justifications for denying disclosure had been further weakened.

The Seventh Circuit did find, however, that a "residual secrecy" remained which was worthy of protection.[62] The court never did define what this residual secrecy was, but it was nevertheless considered in the balancing process. The Seventh Circuit considered the protection of this interest important enough to require restrictions on the use of the grand jury transcripts by the plaintiffs. Since the court failed to make clear what this residual secrecy was, and since there is no apparent basis in *Sarbaugh* for maintaining grand jury secrecy, it is doubtful that a plaintiff in a civil antitrust action will ever be entitled to automatic disclosure of grand jury transcripts pursuant to the usual rules of discovery. The *Sarbaugh* court in effect found that grand jury testimony *per se* is worthy of protection.

The court then analyzed the interests that favored disclosure. The court first pointed out that a need exists for disclosure in order to assure truthful testimony of witnesses at trial.[63] Assuring the truthfulness of deposition testimony was also considered important by the court.[64] The court reasoned that if a witness testifies publicly about matters previously dealt with in his grand jury testimony, "there is little to be said for not allowing the use of his earlier testimony to assure the accuracy of his later testimony."[65]

The court decided that these reasons were sufficient to tip the scales in favor of disclosure of the transcripts. The court went further, however, and stated that fairness to both sides and the interval between the events involved and the testimony of the witnesses at trial also weighed in favor of disclosure.

2. *In Camera* Inspection

The final issue that confronted the Seventh Circuit was whether the judge, once particularized need has been shown, must examine the grand jury transcripts after the witness has testified and release only those portions of the transcripts deemed pertinent.[66] Before the Supreme Court's decision in *Dennis v. United States,* this was the usual practice.[67] In *Dennis,* however, the Supreme

62 552 F.2d at 775.
63 *Id.* at 776.
64 *Id.*
65 *Id.*
66 The Seventh Circuit worded the issue somewhat differently, though it is clear that the court meant to frame the issue in this manner. The court stated that the remaining question was "whether, in order to establish particularized need, it must also be shown that the witness' trial or deposition testimony is inconsistent with his grand jury testimony. . . ." *Id.* A literal reading of this passage suggests that one must show inconsistencies between grand jury testimony and later testimony in order to establish particularized need. Not only would such a showing, if required, effectively bar disclosure, but the Supreme Court has stated specifically that such a showing is not required. *See* Dennis v. United States, 384 U.S. at 874; Pittsburgh Plate Glass Co. v. United States, 360 U.S. at 400-01, 407-08 (Brennan, J., dissenting). Thus, the issue as framed in the text seems preferable.
67 *See, e.g.,* U.S. Industries, Inc. v. United States District Court, 345 F.2d 18 (9th Cir. 1965); United States v. Micele, 327 F.2d 222 (7th Cir. 1964); United States v. Hernandez, 290 F.2d 86 (2d Cir. 1961).

Court held that inspection by the judge before disclosure was no longer necessary in a criminal proceeding, on the grounds that (1) the burden on the trial judge in examining the often voluminous material was too great and (2) the advocate should be the one to distinguish relevant from irrelevant testimony.[68] The Seventh Circuit agreed with this reasoning and applied it to *Sarbaugh*. The court stated that although *Dennis* involved a criminal case, it saw no reason why this procedure could not be expanded into the civil area.

Thus, the Seventh Circuit concluded that since the particularized need shown by the state of Illinois outweighed the "residual secrecy" interest, limited disclosure of the transcripts should be granted to the plaintiffs without *in camera* inspection. The court held that "particularized need is sufficiently shown if the corporate employer of the grand jury witness whose transcript is sought has obtained a copy of that transcript, and the witness is scheduled to be called to give testimony either at trial or by deposition on the matters about which he testified before the grand jury."[69]

The limited disclosure referred to by the court entailed restrictions on the use that the plaintiffs could make of the transcripts. The court limited disclosure to the attorneys of record for use in impeaching witnesses, refreshing the witnesses' recollection, and assuring credibility.[70] As a means of enforcing these limitations, an attorney for the plaintiff was required to maintain a listing of the persons to whom and the purposes for which any portion of a transcript had been shown.[71] Finally, the court prohibited all copying of the transcripts and ordered their return when no longer needed.[72] If the corporate defendants were to contend that a portion of any transcript had no bearing on the civil case, they could move for excision of that portion before disclosure.[73]

C. *Positions of the Second and Fifth Circuits*

The Seventh Circuit proceeded to compare its position on grand jury disclosure with that of other circuits. The Seventh Circuit first addressed the Second Circuit and its dictum in *Baker v. United States Steel Corp.*[74] The holding in this case, as previously discussed, was that an order from the southern New York district court was nonappealable. In dictum, however, the Second Circuit analyzed the issue of particularized need.

The district court judge in Connecticut had been persuaded by the plaintiffs that since most of the policy reasons for secrecy were absent, the particularized need standard should be abandoned.[75] After reviewing the appealability issue,

68 384 U.S. at 874-75.
69 552 F.2d at 777.
70 *Id.* In setting these restrictions on disclosure, the Seventh Circuit quoted directly from the decision rendered by the court in In re Cement-Concrete Block, Chicago Area, 381 F. Supp. 1108, 1110 (N.D. Ill. 1974). The court there stated: "[T]his danger may be obviated by limiting the disclosure to the attorneys of record [in the treble-damage case] for use in that litigation only for the purposes of impeachment, refreshing the witness' recollection and testing credibility."
71 552 F.2d at 777.
72 *Id.*
73 *Id.*
74 492 F.2d 1074 (2d Cir. 1974).
75 *Id.* at 1076.

the Second Circuit pointed out that it did not look favorably upon the relaxation of the standard in the lower court. The court, noting that the transcripts were to be used merely as "leads" to relevant evidence, stated emphatically that it did not agree with allowing disclosure of grand jury transcripts for general discovery purposes.[76] The court did recognize, however, that the impeachment or refreshment of a witness's recollection was sufficient need to justify disclosure.[77]

The Seventh Circuit stated that its decision in *Sarbaugh* was consistent with *Baker*. This is undoubtedly true. Although *Sarbaugh* apparently applied the balancing test used by the district court in *Baker,* the Seventh Circuit's actual holding conforms to the limitations of *Baker*. By allowing disclosure of the transcripts of grand jury witnesses who were scheduled to testify either at trial or at a deposition, it can hardly be said that the Seventh Circuit allowed disclosure for general discovery purposes.

The Seventh Circuit then addressed the Fifth Circuit's position in *Texas v. United States Steel Corp.*[78] In that case, the Fifth Circuit was presented with an appeal from a civil antitrust proceeding in which the plaintiff had sought disclosure directly from the corporate defendants of transcripts obtained by them in a previous criminal proceeding. The Fifth Circuit found that the prior disclosure of the grand jury transcripts to the corporate defendants did not in any way affect the particularized need standard.

The Fifth Circuit reasoned that since the disclosure to a grand jury witness of his own testimony in no way compromises the secrecy of grand jury proceedings, the same holds true when a corporate defendant obtains the testimony of one of its employees who testified before the grand jury. The court held that since a corporation can only speak through its agents, the testimony of the witness is that of the corporation.[79]

The Seventh Circuit claimed that this analogy was inappropriate. By doing so, however, it blatantly contradicted its own position in *Sarbaugh* with respect to the issue of standing.[80] The Seventh Circuit noted that "when a corporation receives disclosure of its employee's grand jury testimony, disclosure has been made to the most likely source of retaliation."[81] The court went on to note that this "[s]urely . . . affects the need for secrecy, . . ." of grand jury proceedings.[82] Thus, although the Seventh Circuit put forth a sound objection to the position taken by the Fifth Circuit, it did so at the expense of contradicting its earlier argument.

D. *Critique*

The holding of the Seventh Circuit in *Sarbaugh,* despite the limitations

76 Id. at 1079.
77 *Id.*
78 546 F.2d 626 (5th Cir. 1977).
79 *Id.* at 630.
80 552 F.2d at 778. It will be recalled that the Seventh Circuit had earlier claimed that Rule 16(a)(1)(A) intimated that the testimony of a corporate employee before a grand jury was actually the testimony of the corporation itself. *See* text accompanying notes 11-14 *supra.* The position taken by the court here directly contradicts this earlier position.
81 552 F.2d at 778.
82 *Id.*

placed on the use of the transcripts, granted the broadest disclosure yet of grand jury transcripts in a civil setting. It expanded on the holding in *U.S. Industries* by allowing the trial judge to disclose the entire transcript without the necessity of an *in camera* inspection. It expanded on *Dennis* by making explicit what was implicit in that case, namely that the particularized need standard is not an inflexible measuring stick but rather varies with the policy considerations involved. In effect, the Seventh Circuit took the best of both cases and combined them in reaching its result.

Nevertheless, it is questionable whether the court in *Sarbaugh* went far enough in its holding. Justice Brennan, in his dissent in *Pittsburgh Plate Glass*, pointed out that "[g]rand jury secrecy is, of course, not an end in itself."[83] He stated that when secrecy no longer serves the ends for which it was established, or when the reasons for disclosure outweigh the interest in secrecy, secrecy should give way.[84] Although the Seventh Circuit went further than any other circuit in granting disclosure of grand jury transcripts in a civil setting, the court seems encumbered by the idea that secrecy is an end in itself.

The court in *Sarbaugh* performed the balancing test mandated by previous Supreme Court rulings. What it failed to make clear, and what appears to make secrecy an end in itself, was exactly what "residual secrecy" was or what it entailed. The court may have been attempting to assure itself that future grand jury witnesses would testify without the fear of having their testimony disclosed at a later time. If the court meant to do this, it could have stated so expressly. Yet even if the court was attempting to assure itself that future grand jury witnesses would testify freely, this consideration should have been given little weight in shaping the holding of the court. It is true that this interest has been considered important in the past, but numerous writers have criticized the validity of this interest as well as other traditional policy reasons for secrecy.[85] For example, any grand jury witness must realize that he or she will probably be called to testify publicly at a later time if an indictment is returned. Thus, the fear of retaliation is present at the moment the witness goes before the grand jury. If he is truly afraid of retaliation, he may change his testimony before the grand jury without waiting to do so at a deposition or trial. Because of this, it is not clear why, where a witness is scheduled to give a deposition or testify at trial, and the corporate defendants already have gained access to his grand jury testimony, automatic disclosure should not be granted to a civil plaintiff who seeks it. Rule 26(c) of the Federal Rules of Civil Procedure[86] provides sufficient protection to the corporate defendant that wishes to protect its interest, if any, in maintaining the

83 360 U.S. at 403.

84 *Id.*

85 *See* Calkins, *Grand Jury Secrecy*, 63 MICH. L. REV. 455 (1965); Traynor, *Ground Lost and Found in Criminal Discovery*, 39 N.Y.U.L. REV. 228 (1964); Sherry, *Grand Jury Minutes: The Unreasonable Rule of Secrecy*, 48 VA. L. REV. 668 (1962).

86 FED. R. CIV. P. 26(c) provides in part:

> Upon motion by a party or by the person from whom discovery is sought, and for good cause shown, the court in which the action is pending or alternatively on matters relating to a deposition, the court in the district where the deposition is to be taken may make any order which justice requires to protect a party or person from . . . oppression, . . . , including one or more of the following . . . ; (4) that certain matters not be inquired into, or that the scope of the discovery be limited to certain matters; . . . .

secrecy of the grand jury transcripts under consideration, since this rule allows a court to issue a protective order under appropriate circumstances. Given the totality of the circumstances in *Sarbaugh,* it seems that the grand jury transcripts should have been as accessible to the plaintiffs as any other documents that were not privileged.

VI. Conclusion

The Seventh Circuit in *Sarbaugh* confronted three issues. The first issue involved the question of whether the corporate defendants had standing to challenge disclosure of grand jury transcripts sought from the government. The court found that the defendants did have standing and that they were thus entitled to intervene in the lower court.

The reasoning used by the court in reaching this conclusion was not altogether sound. Part of the difficulty stemmed from the awkward manner in which the issue was framed. Instead of confronting the standing issue directly, the Seventh Circuit addressed the problem of whether the corporate defendants had the right to intervene in disclosure proceedings. Although standing and the right to intervene involve similar determinations, distinctions do exist. The court never made these distinctions, and as a result the reasoning employed was not at all clear. Perhaps because of this muddled reasoning, the court never identified the interest of the corporate defendants in opposing disclosure. The court simply concluded that such an interest was present and that the right to intervene was thus obvious.

Second, the court had to decide whether the order of the eastern Illinois district court denying disclosure was appealable. The court found that the order was appealable since it terminated proceedings that were independent of and not ancillary to the civil proceedings in the southern Illinois district court. The court noted that the petition for disclosure was filed after the grand jury had been discharged and the criminal action completed. The court also cited to the factors noted in *United States v. Byoir* as supporting the independent nature of the proceedings. The court's reasoning seems sounder on this issue.

On the third issue, the Seventh Circuit confronted an area of the law ripe for expansion and clarification. The court was called upon to weigh the importance of disclosure of grand jury transcripts in federal judicial proceedings against the age-old tradition of grand jury secrecy. In essence, the court was confronted with a clash between the traditional importance of maintaining grand jury secrecy and the more modern trend in civil proceedings of allowing the greatest amount of disclosure possible.

Although the court went further than any other circuit in granting disclosure under the circumstances presented in *Sarbaugh,* it refrained from going as far as it could have. The court did recognize that assuring the truth of a witness's testimony is a valid reason for seeking disclosure. The court also found that this consideration outweighed any possibility of retaliation since the corporate defendants, the most likely parties to retaliate, had already gained access to the transcripts.

Instead of allowing automatic disclosure, however, the court chose to limit disclosure in such a way as to protect a "residual secrecy" that it never defined. The reasons given in support of the court's position on this issue were shallow. It seems clear, however, that *Sarbaugh* can be used to support the proposition that grand jury transcripts should be made available to a civil plaintiff if at all possible, though within strictly defined bounds.

Sarbaugh is an important case. Although the court did not go as far as it could have under the circumstances, the case nevertheless makes a significant contribution to the greater availability of information to a plaintiff during the discovery stage of a civil antitrust proceeding.

James A. Mayotte

CIVIL PROCEDURE—RULE 23—CLASS ACTIONS—THE "NEED" FOR A CLASS SUIT IS NOT A PERTINENT FACTOR IN DETERMINING THE PROPRIETY OF CLASS CERTIFICATION PURSUANT TO RULE 23(B)(2).

*Vickers v. Trainor**

A class action is a device which operates to aggregate small claims for the adjudication of common legal questions. The outcome of the litigation and its corresponding remedies are enhanced by the class action because the effect of the judgment is spread beyond the named parties.[1] The Federal Rules of Civil Procedure require that judgements in class suits specify those whom the court finds to be members of the class.[2] The rationale for this requirement is to determine the extent or coverage of the class remedy and to help prevent unnecessary speculation concerning the res judicata effects of the decision.[3]

In order to acquire class certification, the named plaintiffs must satisfy each subpart of Rule 23(a). Hence, the prospective class must be so large that joinder is impracticable,[4] and there must be common questions of law or fact.[5] The claims of the representatives must be typical of those of other members,[6] and it must be clear that the interests of the class will be adequately protected by the named parties.[7]

In addition to these requirements, at least one subsection of Rule 23(b) must be satisfied. Rule 23(b)(2), the relevant subsection in *Vickers v. Trainor,* states that class certification is proper if those opposing certification have acted in a manner "generally applicable" to the class making class-wide relief "appropriate."[8]

A growing number of courts, when dealing exclusively with prospective remedies pursuant to Rule 23(b)(2), have denied class certification on the grounds that should the plaintiff win injunctive or corresponding declaratory relief,[9] its effect would redound to the benefit of the entire class even without class certification. According to these courts, if nothing is gained by the maintenance of a class suit, certification becomes superfluous. In such cases, the legal protection necessarily extends beyond the named parties, and since class certifica-

* 546 F.2d 739 (7th Cir. 1976).

1 Rendleman, *Prospective Remedies in Constitutional Adjudication,* 78 W. VA. L. REV. 155 (1976).

2 FED. R. CIV. P. 23(c)(3) states that "[t]he judgement in an action maintained as a class action under subdivision (b)(1) or (b)(2), whether or not favorable to the class, shall include and describe those whom the court finds to be members of the class."

3 Advisory Committee's Note, 39 F.R.D. 69, 106 (1966).

4 FED. R. CIV. P. 23(a)(1).

5 FED. R. CIV. P. 23(a)(2).

6 FED. R. CIV. P. 23(a)(3).

7 FED. R. CIV. P. 23(a)(4).

8 FED. R. CIV. P. 23(b)(2) provides:

> [A]n action may be maintained as a class action if the prerequisites of subdivision (a) are satisfied, and in addition: 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.

9 The Advisory Committee's Note states that "Declaratory relief 'corresponds' to injunctive relief when as a practical matter it affords injunctive relief or serves as a basis for later injunctive relief." Advisory Committee's Note, 39 F.R.D. at 102 (1966).

tion is not "needed" to protect the interests of all members of the prospective class, granting injunctive or declaratory relief with respect to the class as a whole is not appropriate within the meaning of Rule 23(b)(2). By acknowledging this fact and denying class certification, courts avoid the time-consuming process of examining the prerequisites to a class action and dealing with the other intricacies of a class suit.[10]

Under these circumstances, proceeding to a quick ruling on the merits of an individual claim is the most efficacious way to protect the interests of the class. When the need for a speedy resolution is imperative and the precedential value of injunctive or declaratory relief for a single plaintiff is great, it may be appropriate to deny class certification and proceed to the merits of the plaintiff's substantive claim. Although many courts operate on this theory, the Seventh Circuit concluded in *Vickers v. Trainor* that "a court may not deny class status because there is no 'need' for it."[11] Thus, in the Seventh Circuit, the "need" for class certification may never influence an evaluation of the propriety of class relief pursuant to Rule 23(b)(2). This analysis must be compared to that which prevails in companion circuits in order to determine under what circumstances it may be proper to deny class certification when a plaintiff seeks exclusively prospective relief under Rule 23(b)(2).[12]

Vickers v. Trainor

The named plaintiffs brought this suit to challenge regulations of the Illinois Department of Public Aid (IDPA) which provide that only recipients of welfare from Aid to Families with Dependent Children (AFDC), Supplemental Security Income (SSI), or Illinois State Supplement Program (SSP) were eligible for state-supported chore and housekeeper services.[13] These benefits provide essential shopping services and light housework to those who because of illness or incapacity would otherwise be unable to remain at home. The plaintiffs were not eligible for these services because they did not receive aid from AFDC, SSI, or SSP.[14] In their fourth and fifth claims, the plaintiffs alleged that the

10 These complexities include motions and orders dealing with such problems as notice and discovery. *See* Notes 53-54 *supra*. *See generally* Manual for Complex Litigation, 1 PT. 2 MOORE'S FEDERAL PRACTICE, Pt. 1 § 1.401 (2d ed. 1977) and 1-6 NEWBERG, NEWBERG ON CLASS ACTIONS (1st ed. 1976).

11 546 F.2d at 747, *quoting* Fujishima v. Board of Educ., 460 F.2d 1335, 1360 (7th Cir. 1972).

12 Several courts of appeal have sustained class actions under Rule 23(b)(2) even when the plaintiffs sought compensatory damages such as back pay. *See, e.g.*, Wetzel v. Liberty Mut. Ins. Co., 508 F.2d 239 (3rd Cir.), *cert. denied*, 421 U.S. 1011 (1975); Pettway v. American Cast Iron Pipe Co., 494 F.2d 211 (5th Cir. 1974). *See generally* Comment, *Class Action Suits—Applicability of Rule 23(B)(2) to Class Actions in which the Need for Injunctive Relief Has Been Obviated*, 37 OHIO ST. L. J. 386 (1976). This comment on *Vickers* considers class actions brought pursuant to Rule 23(b)(2) in which the plaintiffs are seeking *only* injunctive or declaratory relief.

13 The IDPA provides these services as part of a federal-state social services program constructed under Title XX of the Social Security Act. 42 U.S.C. §§ 1397-1397f (1975).

14 The court of appeals noted that the eligibility standards were promulgated in the "State of Illinois Comprehensive Annual Services Plan for Program Year October 1, 1975—June 30, 1977." 546 F.2d at 741. While the plaintiffs received income from sources other than AFDC, SSI, or SSP, they were still without funds to secure services comparable to the state-supported chore and housekeeper benefits. 546 F.2d at 743.

IDPA regulations were contrary to an Illinois statute[15] and that denial of these services deprived them and their class of equal protection of the laws as guaranteed by the fifth and fourteenth amendments to the constitution.[16]

The district court ruled that the plaintiffs had established federal jurisdiction by raising sufficient constitutional and statutory claims. However, it denied the plaintiffs' request for preliminary injunctive relief and class certification. The court concluded that there was no need for class certification because should the plaintiffs prevail on the merits, their victory would redound to the benefit of the entire class.[17] The district court agreed to rule on the merits of the case as quickly as possible, but subsequently decided *sua sponte* to abstain from any action and to refer the proceedings to a state court. The plaintiffs appealed, and the Court of Appeals for the Seventh Circuit reversed and remanded.[18]

In concluding that abstention was inappropriate, the court of appeals admitted that the state law regarding eligibility requirements was unclear and that a ruling in favor of the plaintiffs regarding these standards would moot the equal protection claim.[19] The Illinois courts, however, clearly do not countenance proceedings which challenge eligibility standards for state-supported aid; a state statute prohibits such class actions.[20] Hence the court of appeals predicted that the plaintiffs would be sent from the state court back into the welfare bureaucracy in order to exhaust agency administrative remedies. Stressing the equitable nature of the doctrine of abstention, the federal court refused to ignore the inadequacy and delay inherent in this procedure[21] and held that it was proper for the district court to consider the merits of the plaintiffs' claims.

The court of appeals expressed no opinion as to whether the prerequisites

15 ILL. REV. STAT. ch. 23, § 12-4.11 (1975). This statutory section provides in part:

> [The IDPA is to] establish standards by which need for public aid will be determined and amend such standards from time to time as circumstances may require. The standards shall provide a livelihood compatible with health and well-being for persons eligible for financial aid under any Article of the Code. They shall include recognition of any special needs, such as assistance in shopping . . .

The statute proceeds to provide for chore and housekeeper services.

16 The Seventh Circuit was careful to point out that the plaintiffs did not challenge the constitutionality of the Illinois statute but rather they asserted that the regulations result in an equal protection violation. 546 F.2d at 743 n.5.

17 546 F.2d at 743.

18 In the Seventh Circuit, a stay order by a district court is a sufficiently "final" judgement to invoke appellate review pursuant to 28 U.S.C. § 1291. Drexler v. Southwest DuBois School Corp., 504 F.2d 836 (7th Cir. 1974) (en banc). During the appeal of a final judgement, interlocutory rulings, such as the denial of class certification, are also open for review, and in this manner, the Seventh Circuit could consider the class certification issue in *Vickers*. The court also noted that the denial of a motion pursuant to Rule 23(c)(1) seeking class certification has been held reviewable when the appeal was taken from a denial of a preliminary injunction. Jenkins v. Blue Cross Mut. Hosp. Ins., Inc., 538 F.2d 164, 166 n.2 (7th Cir.) (en banc), *cert. denied*, 429 U.S. 986 (1976).

19 546 F.2d at 744. The Seventh Circuit noted that the Supreme Court has outlined three general categories in which abstention might be appropriate. One of these categories consists of instances when a constitutional issue might be mooted by a clarification of state law in a state court. *See* Colorado River Water Cons. Dist. v. United States, 424 U.S. 800, 813-17 (1976).

20 ILL. REV. STAT. ch. 110, § 265 (1975). *See also* People ex rel. Naughton v. Swank, 58 Ill. 2d 95, 317 N.E.2d 499 (1974); Chicago Welfare Rights Organization v. Weaver, 56 Ill. 2d 33, 305 N.E.2d 140 (1973), *appeal dismissed, cert. denied*, 417 U.S. 962 (1974).

21 The Seventh Circuit refused to ignore this delay because of the severe hardship it would impose on the plaintiffs, who were threatened with "irretrievable confinement" in an institutionalized facility unless they could receive chore and housekeeper services. 546 F.2d at 746.

of Rule 23(a) had been fulfilled. It did note, however, that under Seventh Circuit authority, class status may not be denied because the trial judge views certification as unnecessary. The court of appeals concluded that class status pursuant to Rule 23(b)(2) was practicable. On remand, the district court was instructed to examine the prerequisites of Rule 23(a) "to determine whether the case could properly proceed as a class action."[22]

Seventh Circuit Authority

The watershed case on "need" as a factor in class certification in the Seventh Circuit is *Fujishima v. Board of Education*,[23] in which three high school students sought class certification to challenge the constitutionality of a rule prohibiting the distribution of books without prior approval by the superintendent of schools. The plaintiffs sought declaratory and injunctive relief. In a move which the court of appeals labeled an "apparent disregard" of the Federal Rules of Civil Procedure,[24] the district judge denied the motion for class certification. On appeal, the Seventh Circuit held that "if the prerequisites and conditions of Rule 23 are met, a court may not deny class status because there is no 'need' for it."[25]

Courts in the Seventh Circuit have interpreted and applied *Fujishima* in three ways. First, district courts must examine all aspects of Rule 23 without regard to the need for class status before ruling on a certification motion. In *Metcalf v. Edelman*,[26] the defendant contended that a class action was not necessary to adjudicate the plaintiffs' cause of action. The district court ultimately decided that Rule 23(a)(2) had not been satisfied and that class certification would be inappropriate. The court overlooked the defendant's initial contention that there was no need for class certification and proceeded to analyze the requirements of Rule 23, citing *Fujishima* as authority for that procedure.

Vickers represents a second interpretation of *Fujishima*. According to this view, "need" cannot be a factor in determining the propriety of class relief pursuant to Rule 23(b)(2). If the party opposing the class has acted in a manner generally applicable to each member so that injunctive and declaratory relief is sought for the class, then certification must be granted, assuming the subparts of Rule 23(a) have been fulfilled.[27]

Under the third analysis, if the prerequisites of Rule 23(a) have been fulfilled, a trial court may never deny the named plaintiffs class certification. In *Wilson v. Weaver*,[28] in which the court found all the prerequisites of Rule 23(a) fulfilled and all three subparts of Rule 23(b) satisfied, *Fujishima* is cited as authority for the conclusion that under these circumstances class status cannot be denied.

22 546 F.2d at 747.
23 460 F.2d 1355 (7th Cir. 1972).
24 *Id.* at 1356-57.
25 *Id.* at 1360.
26 64 F.R.D. 407 (N.D. Ill. 1974).
27 An anomaly in the Seventh Circuit authority is Flores v. Kelly, 61 F.R.D. 442 (N.D. Ind. 1973), wherein the plaintiff attacked the constitutional validity of several Indiana statutes, rules, and regulations. The district court concluded that a "class action is not appropriate where the same relief could be afforded without its use." *Id.* at 446. This is precisely the rationale which was rejected by the court of appeals in *Vickers*.
28 358 F. Supp. 1147 (N.D. Ill. 1973), *remanded with instructions*, 519 F.2d 1406 (7th Cir. 1975), *cert. denied*, 424 U.S. 928 (1976).

Summarizing the dicta from these three cases, a district court in the Seventh Circuit cannot consider the need or usefulness of class certification in order to avoid an initial examination of the requirements of Rule 23. When evaluating compliance with Rule 23, *Vickers* suggests that need may not enter the process of determining the propriety of class certification pursuant to Rule 23(b)(2). Finally, if the prerequisites of Rule 23 have been fulfilled, class status may not be denied on the basis of a determination that certification is not necessary.

With the ruling in *Vickers,* the Seventh Circuit has effectively precluded its district courts from considering any factors which may obviate the "need" for class certification and hence establish the impropriety of class relief under Rule 23(b)(2). The Rule itself, however, proclaims that a class can be maintained if the defendant's action has made *appropriate* relief *with respect to the class as a whole.*[29] The Note of the Advisory Committee on Rules emphasizes that the (b)(2) subdivision was intended to reach those circumstances in which injunctive or declaratory relief, "settling the legality of the behavior with respect to the class as a whole, is appropriate."[30] The inference of both the Rule and the Note is that circumstances do exist which indicate that prospective relief with respect to the whole class is not appropriate.

Professor Lucas in *Moore's Federal Practice* characterizes the *Fujishima* position as "an overstatement" of Rule 23 since "the propriety of injunctive or declaratory relief with respect to the class as a whole is the touchstone for this form of class action."[31] An examination of authority in other circuits demonstrates that the *Fujishima-Vickers* position is indeed too rigid. This authority indicates that trial courts perform a valid function when determining whether class certification is "needed" and therefore appropriate within the meaning of Rule 23(b)(2). These cases have succeeded in isolating factors which suggest when class certification under Rule 23(b)(2) is, or is not, appropriate.[32]

Standards for the Propriety of Class Certification under Rule 23(b)(2)

In a case in which the plaintiff seeks exclusively prospective relief and obtains a favorable judgement, the court's decree technically applies only to the named

29 FED. R. CIV. P. 23(b)(2). (Emphasis added).
30 Advisory Committee's Note, 39 F.R.D. at 102 (1966).
31 3B MOORE'S FEDERAL PRACTICE ¶ 23.40 at 92 (2d ed. Supp. 1976).
32 Wright and Miller note that in Rule 23(b)(2) class actions, the relief sought is prospective in nature and tends to benefit all potential class members whether class certification is granted or not. They suggest that the requirements of Rule 23(a) can be relaxed since invalidating a statute or issuing an injunction affects everybody regardless of how stringently the prerequisites of Rule 23(a) are applied. 7 WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE § 1771 (1972). This position is difficult to reconcile with their later comment in support of the *Fujishima* holding: "Despite the soundness of this position (*Fujishima*), several courts have refused to certify actions under Rule 23(b)(2) on the grounds that a class action was not necessary inasmuch as all the class members would benefit from any injunction issued on behalf of the single plaintiff." 7A WRIGHT & MILLER, FEDERAL PRACTICE AND PROCEDURE § 1785 at 67-68 (Supp. 1976).

Although both statements seem to favor liberal use of the class certification device, the basis for the first conclusion conflicts with that of the second. The first position advocates a less stringent application of the prerequisites of Rule 23(a) because injunctive relief will benefit all prospective class members. The effect of endorsing *Fujishima,* however, is to discount any recognition of benefit conferred by individual injunctive relief.

parties.[33] Rule 65 of the Federal Rules of Civil Procedure, however, requires that an injunction be specific in its description of the actions to be restrained.[34] The purpose of this provision is to insure that the defendant knows precisely what activities must be curtailed with respect to the named plaintiffs. Since a proper injunction is detailed, the defendant must realize the fruitlessness of acting in the same way not only toward the named plaintiffs, but also toward those situated as the plaintiffs were in the prior suit.

There are two reasons for this conclusion. First, all future plaintiffs would at least have a strong precedential base upon which to stake their own claim. In addition, each plaintiff might be able to bind the defendant to the initial judgement by an application of collateral estoppel.[35] Although persons situated as the plaintiff are not named in the injunction, benefits from the order redound to all potential class members because of the considerations mentioned above.

The effect of strong precedential value is best exemplified in cases dealing with the constitutionality of the defendant's activities. The plaintiffs in *Ihrke v. Northern States Power Company,*[36] for example, sought declaratory relief in the form of a decree that the regulations of the defendant utility were unconstitutional. No compensatory damages were sought; the plaintiffs simply wanted a ruling that Northern's regulations were unconstitutional in that they sanctioned the termination of services without adequate prior notice and a fair and impartial hearing.

The Eighth Circuit held that class certification was improper because the constitutionality of the regulations could be determined irrespective of how the action was brought. In the words of the *Ihrke* court: "No useful purpose would be served by permitting this case to proceed as a class action."[37]

In *Tyson v. New York City Housing Authority,*[38] the plaintiffs sought declaratory and injunctive relief to prevent their eviction from a public housing project. The allegations included violations of due process, equal protection, and free association as well as a claim that one regulation of the Department of Housing and Urban Development was unconstitutionally vague. The court denied class certification on the grounds that adequate remedies were available to the named plaintiffs and that a constitutional ruling in favor of the plaintiffs would be enough to end the illegal activity of the defendants. The court and both

33 FED. R. CIV. P. 65 (d) states that "[e]very order granting an injunction . . . is binding only upon the parties to the action, their officers, agents, servants, employees, and attorneys, and upon those persons in active concert or participation with them who receive actual notice of the order by personal service or otherwise."

34 FED. R. CIV. P. 65(d) provides that "[e]very order granting an injunction . . . shall set forth the reasons for its issuance; shall be specific in terms; shall describe in reasonable detail, and not by reference to the complaint or other document, the act or acts sought to be restrained."

35 With respect to collateral estoppel, "the controlling precept in federal litigation . . . is that a person who has received a full and fair opportunity to establish a claim or defense should not be allowed a second opportunity to litigate that same claim or defense." Note, *Class Action Judgements and Mutuality of Estoppel,* 43 GEO. WASH. L. REV. 814, 819 (1975). Hence, if the defendant had a full and fair opportunity to defend the initial injunction, then his defeat should preclude him from adjudicating the same issue when other plaintiffs file identical claims. *See* Blonder-Tongue v. University Foundation, 402 U.S. 313 (1971); Bruszewski v. United States, 181 F.2d 419 (3rd Cir. 1950).

36 459 F.2d 566 (8th Cir.), *vacated on other grounds,* 409 U.S. 815 (1972).

37 459 F.2d at 572.

38 369 F. Supp. 513 (S.D. N.Y. 1974).

present and future members of any proposed class could "properly assume that an agency of government will not persist in taking actions which violate the rights of the tenants."[39]

Thus, if the facts of a case are such that it is fair to presume that precedent emanating from a single party judgement will prompt the defendant to conform his general activities to that decree, then a class suit to enlarge the ambit of prospective relief is superfluous.[40] Precisely when the strength of precedent is overwhelming enough to merit denial of class certification under Rule 23(b)(2) is not always apparent. Thus, a court should err, if at all, in favor of maintenance of the class.[41] In cases involving constitutional claims, however, a decree from the federal courts carries enough weight to abolish constitutionally repugnant activities, particularly when the defendant is an agency of the government.[42]

In cases not involving constitutional claims, injunctive relief in favor of the named plaintiffs alone may still redound to the benefit of all proposed class members. The plaintiffs in *Martinez v. Richardson*[43] sought class status in their quest for injunctive relief against the Secretary of Health, Education, and Welfare and other named defendants. Their primary objective was to prevent the termination of certain home health care benefits provided under Medicare.

The Tenth Circuit acknowledged Rule 23(b)(2) as a potential remedial device but concluded that class certification was unnecessary since the same relief could be afforded without its use.[44] The district court was instructed to fashion its decree "so as to make certain that there will be future compliance with the law. . . ."[45] Hence, the trial court could indicate its intention to adhere to the precedent of its current decree and thus reduce the threat of habitual resistance to the court's judgement. In this manner, the plaintiff's remedy is spread beyond the named litigants to all purported members of the class since insufferable policies are corrected and, in effect, monitored by the court.

The rationale behind *Martinez* and *Ihrke* suggests that there are instances in which class certification pursuant to Rule 23 (b)(2) is not "needed" and is, therefore, inappropriate. According to these cases, it is proper to deny certification entirely apart from whether the prerequisites of Rule 23(a) have been fulfilled, since class status may not be granted unless subdivision (b)(2) has been satisfied.[46]

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39 *Id.* at 516.

40 The Manual for Complex Litigation suggests that "[i]t is rarely necessary, for instance, to maintain a class action in cases in which declaratory or injunctive relief is sought because of the alleged facial unconstitutionality of a federal or state statute or regulation." 1 PT. 2 MOORE'S FEDERAL PRACTICE, Pt. 1 § 1.401 (2d ed. 1977).

41 At least one court has pointed out that although (b)(2) certification does not significantly widen the scope of judicial relief, the defendant gains protection from repetitive suits since the class is bound by res judicata should the defendant emerge victorious. Paddison v. Fidelity Bank, 60 F.R.D. 695 (E.D. Pa. 1973). This is one argument for always granting class certification.

42 "Insofar as the relief sought is prohibitory, an action seeking declaratory or injunctive relief against state officials on the ground of unconstitutionality of a statute or administrative practice is the archtype of one where class action designation is largely a formality, at least for the plaintiffs." Galvan v. Levine, 490 F.2d 1255, 1261 (2nd Cir. 1973). *See also* McDonald v. McLucas, 371 F. Supp. 831 (S.D. N.Y. 1974).

43 472 F.2d 1121 (10th Cir. 1973).

44 *Id.* at 1127.

45 *Id.* at 1127.

46 This examination is limited to actions seeking exclusively prospective relief pursuant to

Subsequent district court cases have utilized this rationale to reach similar results. In *Coffin v. Secretary of Health, Education, and Welfare,*[47] the plaintiff sought to represent a class of men who, but for a dependency requirement, would be eligible for benefits under the Social Security Act. The court concluded that resort to a class action was not necessary since a decree could be fashioned giving relief to all persons similarly situated. "Where such a situation exists, a class action is neither useful nor required."[48] Similarly, in *District of Columbia Podiatry Soc. v. District of Columbia,*[49] the plaintiffs alleged discrimination against podiatrists in violation of the Social Security Act and the due process clause of the fifth amendment. In deciding not to grant class status for declaratory and injunctive relief under Rule 23(b)(2), the court looked at the trend set by *Ihrke* and *Martinez,* and, as in *Coffin,* rejected the *Fujishima* opinion with the quote from *Moore's Federal Practice* that the Seventh Circuit's position is an "over-statement."[50]

The circumstances discussed thus far deal primarily with whether or not the type of prospective relief in an individual cause of action will redound to the benefit of the entire class and hence obviate the need for class certification pursuant to Rule 23(b)(2). As in *Martinez,* an indication of the court's intention to grant similar relief in the future should the defendant persist in illegal conduct can effectively assure relief to the whole "class." The court in many instances should be able to determine whether this would result by examining the nature of the relief sought and the substantive issues raised in the complaint. A denial of class certification as unnecessary and hence inappropriate can thus occur before a court even addresses the prerequisites established by Rule 23(a).

The *Fujishima-Vickers* doctrine also prevents a court from examining questions concerning the manageability of class suits and their effect on litigants and the court. Under the law as it now stands, courts in the Seventh Circuit must ignore these factors, as well as the "scope of relief" considerations outlined above, in determining whether class certification is "appropriate" under Rule 23(b)(2).

Judicial economy is an important consideration when evaluating the propriety of certain court procedures. Class actions were developed largely to serve the ends of judicial economy.[51] Nevertheless, when comparable relief can be fashioned without class certification, delays inherent in class actions are not only a waste of the court's time and money, they can also cause undue hardship on litigants who are suffering daily from illegal activities.[52] In determining the propriety of class certification under Rule 23(b)(2), courts should be authorized to consider these delays when they will place an undue burden on the litigants and when the prospective relief will benefit all those similarly situated without class certification.

Instances in which final prospective relief with respect to the class as a

Rule 23(b)(2). If a plaintiff fails to meet certification standards under (b)(2), he may still be able to acquire class status pursuant to another subsection of Rule 23(b).

47 400 F. Supp. 953 (D.D.C. 1975), *appeal dismissed,* 97 S.Ct. 1539 (1977).

48 400 F. Supp. at 956.

49 65 F.R.D. 113 (D.D.C. 1974).

50 *Id.* at 114-15.

51 1 NEWBERG, NEWBERG ON CLASS ACTIONS § 1004, at 16-17 (1st ed. 1976).

52 *See* note 21 *supra.*

whole *is* appropriate certainly include cases in which the court realizes that its decree in a single cause of action cannot or may not protect the interests of all those similarly situated. The court might decide class certification is proper because the defendant has been particularly insolent by not respecting past precedent. The added weight and publicity of a class action may insure prompt and expansive compliance. If the court suspects that notice to all class members will be required to protect the class or to guarantee fair conduct in the action, class certification may be appropriate to enable the court to exercise its option under Rule 23(d)(2) and require notice.[53] Also, if a full and fair adjudication can only be realized with expanded discovery, the court may grant class status to make other members of the class parties to the action and hence subject to discovery procedures.[54] In determining whether or not to grant certification pursuant to Rule 23(b)(2), the court must weigh factors militating for the maintenance of class certification against those which suggest class relief is inappropriate to an expeditious and just resolution of the claim.

Assuming the plaintiffs have fulfilled the prerequisites of Rule 23(a), the court should err, if at all, in favor of class certification. In those instances in which the adjudication of a single cause of action will result in relief which will be as expansive and thorough as class relief, however, the court should have the option of immediately proceeding to the merits of the claim. This determination can be made before ruling on the other requirements expounded in Rule 23.

The Propriety of Class Certification in Vickers

Vickers exemplifies precisely the type of case in which a district court should have the opportunity to decide the propriety of class certification under Rule 23(b)(2). The plaintiffs were alleging violations of various state and federal laws as well as a violation of their constitutionally guaranteed rights. The district court apparently felt that it could, without allowing class certification, fashion its decree to benefit all those whom the plaintiffs were seeking to represent. There was no need for, nor benefit to be gained from, class certification.[55]

53 FED. R. CIV. P. 23(d)(2) provides that a court may make appropriate orders "for the protection of the members of the class or otherwise for the fair conduct of the action, that notice be given in such manner as the court may direct to some or all of the members of any step in the action . . ." The Second Circuit in Eisen v. Carlisle & Jacquelin, 391 F.2d 555 (2d Cir. 1968) [Eisen II], stated that notice is required as a matter of due process in all representative actions. Thus, in courts adopting this authority, when any class suit is brought pursuant to Rule 23(b)(2), sending notice to all class members is required. This would impose a substantial burden on class representatives in a suit like *Vickers* in which the plaintiffs may have to scrutinize welfare rolls in order to determine the whereabouts of members of the class just to send them proper notice of the action. The Seventh Circuit adopted the *Eisen II* position in Schrader v. Selective Service Sys. Loc. Bd. No. 76 of Wis., 470 F.2d 73 (7th Cir.), *cert. denied,* 409 U.S. 1085 (1972). This rule, however, is presently in serious doubt, as the Seventh Circuit has indicated that it will have to reconsider its position. *See* Jimenez v. Weinberger, 523 F.2d 689, 700 n.25 (7th Cir. 1975), *cert. denied,* 427 U.S. 912 (1977); Bijeol v. Benson, 513 F.2d 965, 968 n.3 (7th Cir. 1975). Even absent a strict requirement, however, the court at its discretion may want to order notice in a Rule 23(b)(2) action pursuant to Rule 23(d)(2).

54 FED. R. CIV. P. 23(d), entitled "Orders in Conduct of Actions," gives the trial judge discretion to deal with various procedural matters. The judge can make orders relating to discovery under the auspices of this section. *See generally* Fulham, *Federal Rule 23—An Exercise in Utility,* 38 J. AIR L. & COM. 369, 381-85 (1972).

55 546 F.2d at 743. The plaintiffs abandoned their constitutional claim at the appellate level. 546 F.2d at 743 n.5. The foregoing analysis still applies to the *Vickers* case, however,

Each consideration bearing on the propriety of class certification has some application in this case. First, the injunctive relief sought by the plaintiffs could be issued so that its benefits would accrue to the entire class. An order striking down the IDPA restrictions on eligibility requirements for chore and housekeeping services would make available additional welfare benefits to all those persons who, but for the present discriminatory standards, would be eligible to receive them. In addition, the court could indicate its intention to grant similar relief in the future should the defendant fail to curtail its unlawful activities.

Furthermore, the plaintiffs presented a constitutional claim, and its resolution in favor of the individual plaintiffs should be sufficient to abrogate the policies of the defendant. The defendant is an agency of the government and, as in *Tyson,* it is fair to conclude that the agency will amend its regulations to conform to an order of the federal court.

A third reason for promptly denying class certification in *Vickers* is the delay inherent in class suits and the resulting protraction of an otherwise more expeditious adjudication. The Seventh Circuit acknowledged the desperation of the plaintiffs' condition when it noted that the "substantial possibility of their potentially irretrievable confinement"[56] was but one more reason to order the district court to forego the abstention doctrine and consider the merits of the case. Any delay due to the maintenance of a class action will similarly jeopardize the plaintiffs' independence from institutional care. In determining whether final prospective relief with respect to any class is appropriate, courts should be able to decide against a class suit if individual relief will benefit the entire class and if, as here, the delays inherent in the maintenance of a class action stand to injure the individual litigants.

Overruling the denial of class certification, the *Vickers* court stated that the district court not only contravened *Fujishima,* but it "also did not comply with the plain language of Rule 23(c)(1)."[57] Rule 23(c)(1) provides that "as soon as practicable after the commencement of an action brought as a class action, the court shall determine by order whether it is to be so maintained."[58] The Advisory Committee's Note states that "[t]he determination depends in each case on the satisfaction of the terms of subdivision (a) and the relevant provisions of subdivision (b)."[59] The court of appeals felt that certification under Rule 23(b)(2) was practicable. It chastised the district court for failing to consider the prerequisites expounded by Rule 23(a) and concluded that the lower court had not complied with the plain language of Rule 23(c)(1).

If the *Vickers* court had rejected *Fujishima* and accepted the authority of other circuits, however, it would have seen that the plaintiffs had already failed to meet Rule 23(b)(2). Hence, in evaluating compliance with subdivision

because this comment deals with standards for class certification to be applied by a trial judge. The district judge in *Vickers* had to consider a constitutional claim, as well as statutory claims, when ruling on the plaintiffs' certification motion.

The federal court maintained jurisdiction even after the constitutional claim was abandoned because the plaintiffs' alleged violations of both Title XX of the Social Security Act and 45 C.F.R. § 228.34(d). 546 F.2d at 741-42.

56 546 F.2d at 746. *See* note 21 *supra.*

57 *Id.* at 747.

58 FED. R. CIV. P. 23(c)(1).

59 Advisory Committee's Note, 39 F.R.D. at 104 (1966).

(c)(1), the district court was not bound to consider Rule 23(a). Fulfillment of one provision in part (b) of Rule 23 is a necessary, though not sufficient, requirement to the maintenance of the class,[60] and the failure of the plaintiffs to meet that standard absolved the court from examining subdivision (a). The district court decided against class certification because it adopted the view that class relief is not appropriate when comparable relief can be awarded in a more expeditious fashion simply by proceeding with the individual claim. Although class relief was an alternative, it was not an appropriate one within the meaning of Rule 23(b)(2). Based on this interpretation of subdivision (b)(2), the district court did comply with the plain language of Rule 23(c)(1) by immediately denying class certification. Applying *Fujishima,* however, the Seventh Circuit concluded otherwise and held that Rule 23(b)(2) had been fulfilled, thus necessitating examination of the requirements of Rule 23(a).[61]

At the time the district judge denied class certification in *Fujishima,* he ruled on several other motions and dismissed the case.[62] A motion for a preliminary injunction was granted and made permanent. This order contravened Rule 65 by granting an injunction without a hearing and by not describing the acts restrained or the reason for its issuance.[63] After issuing the order, the district judge announced "under this decision I find that there is no need for a class action."[64] Consequently, the motion for class certification was denied. In response to this situation, the Seventh Circuit concluded that "a court may not deny class status because there is no 'need' for it."[65]

The holding in *Fujishima* should be limited to the bizarre circumstances out of which the decision arose. The use of the word "need" by the district judge is amorphous and inconclusive, and there is no indication that the court considered standards, such as those developed in *Martinez* and *Ihrke,* to determine what effect individual relief might have on persons similarly situated. Since the district judge apparently disregarded Rules 56, 57, and 65,[66] it is difficult to determine whether he applied Rule 23 or summarily denied class certification simply because he intended to dismiss the case after granting injunctive relief. *Fujishima* should be construed so that the prohibition on denying class certification when there is no "need" for it refers specifically to "need" as the district judge there employed

60 FED. R. CIV. P. 23(b) dictates that a class action may be maintained if each provision of subdivision (a) is satisfied and one part of subdivision (b) is fulfilled.

61 Jimenez v. Weinberger, 523 F.2d 689 (7th Cir. 1975), *cert. denied,* 427 U.S. 912 (1977), indicates that in some cases, the order granting certification need not be made until the merits of the case are decided (though certainly not afterwards). The appellants in *Vickers* apparently argued that since it was still possible for the district judge to grant class certification up until a decision on the merits, the court could disregard the *Fujishima* opinion. Yet the circumstances in *Vickers* were not exemplary of the type of cases which *Jimenez* described as meriting postponement of a certification decision until a decision on the merits. The court properly dismissed the appellants' argument because in cases such as *Vickers,* Rule 23(c)(1) requires that the certification decision be made as soon as practicable after the initiation of the suit. Even though the district judge in *Vickers* might have retained the power to reconsider his denial of certification, the court must not sanction delays in making a permanent Rule 23(c)(1) order.

62 460 F.2d at 1356-57.

63 *See* note 28 *supra.*

64 460 F.2d at 1360.

65 *Id.* at 1360.

66 FED. R. CIV. P. 56 deals with summary judgements. FED. R. CIV. P. 57 covers declaratory judgements. FED. R. CIV. P. 65 provides for injunctions.

the term. Otherwise, the Seventh Circuit's overly broad interpretation of Rule 23(b)(2) will require class certification *whenever* prospective relief is sought rather than when it is appropriate.[67]

By limiting *Fujishima,* the precedential value of its holding would be severely curtailed and district courts could determine the propriety of class certification within the meaning of Rule 23(b)(2) by applying the standards enumerated in cases such as *Ihrke* and *Martinez. Vickers* should be construed as a misinterpretation of the true significance of *Fujishima.*

Fujishima was cited in *Wilson* and *Metcalf* to emphasize that the absence of a need for class status may not be asserted as an excuse for an initial failure to examine the requirements of Rule 23 or to deny class certification after finding the prerequisites fulfilled. These concepts remain unaffected even after restricting the holding in *Fujishima.* When "need" is examined in the *Ihrke* and *Martinez* sense, the court does not avoid examining the requirements of Rule 23. Rather, it employs "need" in the process of determining whether subdivision (b)(2) is satisfied. Similarly, if the uselessness of class certification indicates that a Rule 23(b)(2) action is inappropriate, then one of the prerequisites of Rule 23 has not been met and class status must be denied.

Conclusion

The holding in *Fujishima* that class certification may not be denied simply because there is no "need" for it has been misapplied by the Seventh Circuit. The rule that "need" cannot be a factor in determining the propriety of class certification pursuant to subdivision (b)(2) is contrary to the clear implication of Rule 23 that the defendant must have acted in a way making *appropriate* class-wide relief. *Vickers* creates the enigmatic result that Rule 23 (b)(2) is satisfied whenever the named plaintiffs seek injunctive or declaratory relief rather than when class relief is appropriate. Clearly, the propriety of class relief is the "touchstone" of class certification pursuant to Rule 23(b)(2).[68]

Standards to determine the propriety of certification within the meaning of subdivision (b)(2) have been enumerated by several courts. The primary concern is whether the court can fashion its decree so that injunctive or declaratory relief redounds to the benefit of the entire proposed class. In these circumstances, certification may be superfluous and, hence, inappropriate. When the precedential value of a court decree is great or its corrective effect assured, class certification may not be needed to adjudicate substantive claims of law. In these circumstances, repugnant activities are silenced by the favorable resolution of a single claim and the interests of all prospective class members are protected. Finally, if the entire proposed class will benefit from prospective relief won by a single plaintiff, additional weight may be given to the undue burden class certification may impose on the litigants.

In *Vickers,* the district judge was confident he could fashion relief that would protect the interests of all proposed class members. He should have had the op-

67 While the circuit court's interpretation of Rule 23(b)(2) is overly broad, its effect on the district courts is restrictive in that the trial judge no longer has the discretion to determine the propriety of class certification.

68 *See* note 8 *supra.*

portunity to determine that class certification was inappropriate. By extending the *Fujishima* holding in *Vickers* so that subdivision (b)(2) of Rule 23 is satisfied whenever the plaintiff seeks prospective relief, the Seventh Circuit utilized an overly broad interpretation of the Federal Rules of Civil Procedure. *Fujishima* should be limited to its facts and *Vickers* should be construed as a misapplication of *Fujishima*. In this manner, district courts could rightfully deny class certification when such relief is inappropriate within the meaning of Rule 23(b)(2).

Arthur A. Vogel, Jr.

CRIMINAL PROCEDURE—Admissibility of Confession—Proof of Working Arrangement Required Before Defense of Unnecessary Delay Available—Judicial Discretion Permitted to Exclude Confession When Delay Is in Excess of Six Hours.

*United States v. Gaines**

When an error of law is made by a trial judge, an appellate court, in reversing the decision, must provide guidelines for the correct application of legal principles. The need for adequate guidelines is especially prevalent in cases in which the trial judge must exercise a broad degree of judicial discretion and thus requires a framework in which to apply the law. The failure of an appellate court to interpret principles of law leaves critical questions to be decided with little direction. Such was the case in *United States v. Gaines*.[1]

On March 18, 1972, defendant-appellee Rufus Gaines was detained by store employees for shoplifting and was subsequently removed to state police headquarters where he was charged with theft and shoplifting.[2] Prior to this arrest, Gaines had been the focus of a discussion between federal and state officials because of his suspected involvement in a federal crime. Cognizant that Gaines was wanted by federal authorities, the state police notified the FBI, who arrived that afternoon to interrogate Gaines. Neither the federal nor the state officers questioned Gaines the following day, but during questioning on the third day, Gaines confessed to federal officers.

After taking Gaines into federal custody, the officers brought Gaines before a federal magistrate in accordance with Rule 5(a),[3] which requires that a person arrested by federal authorities be arraigned without unnecessary delay. Until that time, forty-six hours after his arrest by state officials, Gaines had not been taken before a magistrate.

At the suppression hearing, Gaines moved to exclude his confession on the ground it was elicited in violation of Rule 5(a). In support of his allegation of unnecessary delay, Gaines attempted to establish the existence of a working arrangement between federal and state officers. Federal courts have held that when a state arrest was "designingly utilized to circumvent Rule 5(a),"[4] the time spent in state custody can be considered in the determination of unnecessary delay. To establish the existence of a working arrangement, Gaines introduced as evidence his jail classification card, which stated that he was being held for investigation, and his public record sheet, which carried the notations "Do not

* 555 F.2d 618 (7th Cir. 1977).

1 555 F.2d 618 (7th Cir. 1977).

2 Some of the details of the case are taken from a previous appeal: United States v. English, 501 F.2d 1254 (7th Cir. 1974), *cert. denied*, 419 U.S. 1114 (1975). Gaines' first conviction was reversed in United States v. Gaines, 529 F.2d 1038 (7th Cir. 1976).

3 The applicable part of Rule 5(a), Fed. R. Crim. P. provides:

> An officer making an arrest under a warrant issued upon a complaint or any person making an arrest without a warrant shall take the arrested person without unnecessary delay before the nearest available federal magistrate or, in the event that a federal magistrate is not reasonably available, before a state or local judicial officer authorized by 18 U.S.C. § 3041.

4 United States v. Chadwick, 415 F.2d 167, 171 (10th Cir. 1969).

release" and "to hold for FBI, Agent Whitaker."[5] Agent Whitaker testified that he had daily contact with the state police and that there was "a continuing, ongoing inquiry" relating to the federal crimes of which Gaines was suspected.[6] Evidence adduced at the hearing also indicated that the state court had been in session for the duration of Gaines' detention furnishing sufficient opportunity for the police to prefer charges against Gaines for theft and shoplifting—the state offenses which were the ostensible reason for his arrest.

The trial judge made no definitive ruling on whether a working arrangement existed, but concluded that the time spent in state custody was relevant to the Rule 5(a) inquiry. In deciding whether the confession should be suppressed, the trial judge then considered both 18 U.S.C. § 3501,[7] a federal statute embodying guidelines for the voluntariness and admissibility of a confession, and the unnecessary delay requirement of Rule 5(a). The trial judge ruled that the confession was voluntary and recognized that Gaines was brought before a federal magistrate soon after federal custody commenced. Nevertheless, believing it was

5 *See* 555 F.2d at 621.

6 *Id.* at 621.

7 18 U.S.C. § 3501 (1970) provides:

(a) In any criminal prosecution brought by the United States or by the District of Columbia, a confession, as defined in subsection (a) hereof, shall be admissible in evidence if it is voluntarily given. Before such confession is received in evidence, the trial judge shall, out of the presence of the jury, determine any issue as to voluntariness. If the trial judge determines that the confession was voluntarily made it shall be admitted in evidence and the trial judge shall permit the jury to hear relevant evidence on the issue of voluntariness and shall instruct the jury to give such weight to the confession as the jury feels it deserves under all the circumstances.

(b) The trial judge in determining the issue of voluntariness shall take into consideration all the circumstances surrounding the giving of the confession, including (1) the time elapsing between arrest and arraignment of the defendant making the confession, if it was made after arrest and before arraignment, (2) whether such defendant knew the nature of the offense with which he was charged or of which he was suspected at the time of making the confession, (3) whether or not such defendant was advised or knew that he was not required to make any statement and that any such statement could be used against him, (4) whether or not such defendant had been advised prior to questioning of his right to the assistance of counsel; and (5) whether or not such defendant was without the assistance of counsel when questioned and when giving such confession.

The presence or absence of any of the above-mentioned factors to be taken into consideration by the judge need not be conclusive on the issue of voluntariness of the confession.

(c) In any criminal prosecution by the United States or by the District of Columbia, a confession made or given by a person who is a defendant therein. while such person was under arrest or other detention in the custody of any law enforcement officer or law enforcement agency, shall not be inadmissible solely because of delay in bringing such person before a magistrate or other officer empowered to commit persons charged with offenses against the laws of the United States or of the District of Columbia if such confession is found by the trial judge to have been made voluntarily and if the weight to be given the confession is left to the jury and if such confession was made or given by such person within six hours immediately following his arrest or other detention: Provided, That the time limitation contained in this subsection shall not apply in any case in which the delay in bringing such person before such magistrate or other officer beyond such six-hour period is found by the trial judge to be reasonable considering the means of transportation and the distance to be traveled to the nearest available such magistrate or other officer.

(d) Nothing contained in this section shall bar the admission in evidence of any confession made or given voluntarily by any person to any other person without interrogation by anyone, or at any time at which the person who made or gave such confession was not under arrest or other detention.

(e) As used in this section, the term "confession" means any confession of guilt of any criminal offense or any self-incriminating statement made or given orally or in writing.

his duty under case law and authorities, the judge reluctantly suppressed the confession because of the unreasonable delay between commencement of state custody and arraignment before a magistrate.[8] The government appealed from the order of the district court granting Gaines' motion to suppress evidence of a confession.

On appeal, the Seventh Circuit had to determine whether the trial judge correctly concluded that he was bound to suppress the confession. The Seventh Circuit reversed and remanded *Gaines* because the findings of the district court did not affirmatively indicate that a working arrangement existed. Since federal officers brought Gaines before a magistrate shortly after federal custody began, Gaines would have to prove that a working arrangement existed in order to prevail on his defense of unnecessary delay. In addressing the ancillary issue of unnecessary delay, the Seventh Circuit held only that the trial judge retained discretion in determining the admissibility of a confession—it did not resolve the issue of unnecessary delay itself.

Resolution of the issues on appeal in *Gaines* should have involved two levels of inquiry: (1) whether there was a working arrangement and, if so, (2) whether there was unnecessary delay which would preclude the admission of the confession as evidence. Because the district court findings did not affirmatively indicate the existence of a working arrangement, the Seventh Circuit did not have to address the related issue of unnecessary delay. Perhaps fearing that a working arrangement would be found or perhaps addressing the district judge's reluctance in excluding the confession, the Seventh Circuit nevertheless attempted to give some guidance on the issue of unnecessary delay.

Guidance was indeed necessary since the interaction between Rule 5 (a) and § 3501 has been the source of conflicting interpretations in the federal courts.[9] One interpretation, applied in *United States v. Halbert*,[10] reflects the legislative history of the statute and emphasizes voluntariness. Under the *Halbert* interpretation, delay is one factor to be considered in determining voluntariness and is never alone sufficient to cause a confession to be excluded. The other interpretation, exemplified by *United States v. Erving*,[11] reflects the standards promulgated by the Supreme Court in *United States v. McNabb*,[12] *United States v. Mallory*,[13]

8 *See* 555 F.2d at 620, 622.

> [I] believe, because of the delay between the time the defendant was taken into custody — and it is undisputed that he was not taken before a magistrate for any purpose until shortly after he was brought into Federal custody — I believe that it is my duty under the law and under the cases and under the authorities to suppress this confession and I do so with great reluctance. . . .
>
> It is terribly unfortunate that very competent and able Federal law enforcement officers are bound by the time that this defendant was in custody, up to the time he gave the statement, but I think they are, and I don't think the fact that he was in State custody for a while and immediately when he got into federal custody — I don't think that helps the Federal Government on this issue. It should, but it doesn't.

9 The Seventh Circuit had previously held, in United States v. Davis, that Rule 5(a) was to be interpreted in conjunction with § 3501. United States v. Davis, 532 F.2d 22 (7th Cir. 1976). In *Davis*, however, the extent of the interaction between § 3501 and Rule 5(a) was not fully examined as only a two-hour delay was at issue.

10 436 F.2d 1226 (9th Cir. 1970).

11 388 F. Supp. 1011 (W.D. Wis. 1975).

12 318 U.S. 332 (1943).

13 354 U.S. 449 (1957).

and *Miranda v. Arizona.*[14] Under the *Erving* interpretation, delay alone may be sufficient to cause a confession to be excluded.

Because § 3501 has not yet been construed in the Seventh Circuit the district court's suppression order was entered without any express guidance from the Seventh Circuit. Added to this difficulty was the fact that the decided cases construing § 3501 have arrived at conflicting interpretations. After giving cursory review to the conflicting interpretation which § 3501 has received, the Seventh Circuit concluded that, regardless of the construction given § 3501, the trial judge retains discretion in determining the admissibility of the confession. This comment addresses both the working arrangement and delay issues in *Gaines* and the effect of the Seventh Circuit's failure to render an interpretation of § 3501 with regard to each of these issues.

Evolution of 18 U.S.C. § 3501

The companion cases of *Anderson v. United States*[15] and *McNabb v. United States*[16] are the foundation for the doctrines of working arrangement and unnecessary delay. Both decisions were an exercise of the Supreme Court's supervisory authority over the administration of criminal justice in the federal courts, and were intended to correct an affront to judicial integrity caused by the failure of police officials to follow required procedures.

A defense predicated on a working arrangement which subsequently violates the rights of an accused was initially recognized in *Anderson.* In *Anderson,* the defendants were nominally in the custody of Tennessee authorities but were, in fact, federal prisoners. Having been arrested by the sheriff without a warrant on suspicion of destroying property, the six defendants, without being brought before a magistrate, were subjected to long questioning by federal officers "in the hostile atmosphere of a small company-dominated mining town."[17]

The Supreme Court found that there was a working arrangement between the federal officers and the sheriff that made the abuses possible. Thus, even though the federal officers themselves were not formally guilty of illegal conduct, the confession was still inadmissible as it was secured improperly through collaboration with state officers.

In *McNabb,* the Supreme Court noted that federal statutes[18] requiring the prompt arraignment of an accused person constituted "an important safeguard —not only in assuring protection for the innocent but also in securing conviction of the guilty by methods that commend themselves to a progressive and self-confident society."[19] In *McNabb,* the petitioners, uneducated mountaineers, had

14 384 U.S. 436 (1966).
15 318 U.S. 350 (1943).
16 318 U.S. 332 (1943).
17 *Id.* at 356.
18 The Supreme Court cited three federal statutes requiring prompt arraignment: 18 U.S.C. § 595 (persons arrested to be taken before the nearest officer for hearing); 18 U.S.C. § 593 (arrested persons in act of operating an illicit distillery to be taken before a judicial officer); and 5 U.S.C. § 300(a) (officers of F.B.I. to take arrested person before a committing officer). 18 U.S.C. § 593 and § 595 have been superseded by Rule 5. 5 U.S.C. § 300(a) is now 18 U.S.C. §§ 3052, 3107. The Supreme Court, in a footnote, noted that many states have prompt arraignment statutes.
19 *See* 318 U.S. at 344.

been arrested by federal officers for the murder of an officer of the Alcohol Tax Unit of the Bureau of Internal Revenue. The McNabbs were kept in a barren cell for fourteen hours after being arrested in the early hours of the morning. Held incommunicado from any friends, relatives, or an attorney, they were subjected to unremitting questioning, singly and together, for two days. In holding the resulting confessions inadmissible, the Supreme Court emphasized the circumstances under which the confessions were elicited and, because of the flagrant disregard of procedure, refused to uphold the convictions lest the court become an accomplice in willful disobedience of the law.

In cases subsequent to *Anderson* and *McNabb,* defenses based on a working arrangement became extremely difficult to prove while defenses based on unnecessary delay were subjected to ambiguous judicial interpretation. Because the courts did not want to interfere unduly with cooperation between state and federal officials, the mere fact that a concurrent investigation of the same suspect was under way or that separate agencies were cooperating to solve a crime was not deemed sufficient to constitute a working arrangement. The defendant had to prove that the state custody was "designingly utilized"[20] to circumvent Rule 5(a), or at the very least, that the delay "was deliberately induced for the express purpose of producing evidence."[21] To some extent, this prerequisite showing of a working arrangement may have been the basis of the *McNabb* Court's insistence on a stricter unnecessary delay standard.

Because the decision in *McNabb* was based on the circumstances surrounding the detention, federal courts were uncertain as to when and under what circumstances the exclusionary rule was applicable. At least one court interpreted *McNabb* as holding that *any* unreasonable delay required exclusion.[22] Other courts, however, required the presence of coercion, either psychological or physical, before evidence obtained during the delay would be excluded. In an attempt to resolve some of the ambiguities created by the *McNabb* decision, the Supreme Court again addressed the issue of unreasonable delay in *United States v. Mitchell.*[23] In *Mitchell,* the Court held that a "threshold" confession (made immediately upon arrest) followed by an extensive delay was admissible as it was not the result of inexcusable detention for the purpose of extracting evidence. Though the *McNabb* doctrine was not applied in *Mitchell,* the Supreme Court, in dicta, affirmed the observation in *McNabb* that the exclusionary rule arose solely from the unreasonable delay regardless of the voluntariness of the confession.

The *McNabb* and *Mitchell* decisions, however, did not delineate guidelines indicating when the exclusionary rule was to be applied. Some guidance was given by the Supreme Court in *Upshaw v. United States.*[24] In *Upshaw* the defendant was arrested by District of Columbia police without a warrant on

20 United States v. Chadwick, 415 F.2d 167, 171 (10th Cir. 1969).
21 United States v. Hamilton, 409 F.2d 404, 406 (7th Cir. 1969).
22 United States v. Haupt, 136 F.2d 661, 668 (1943), in dictum quoted the *McNabb* opinion: "The mere fact that a confession was made while in the custody of police does not render it inadmissible." The court concluded that "[t]his statement undoubtedly refers only to a confession made subsequent to the officer's compliance with the statutory mandate."
23 322 U.S. 65 (1944).
24 335 U.S. 410 (1948).

suspicion of larceny and questioned for 30 hours. The district court held that the confession obtained during the questioning was admissible since the detention of the petitioner was not unreasonable under the circumstances. On appeal, the District of Columbia Circuit, rejecting the U.S. Attorney's confession of error, held the confession admissible since it was voluntarily given under conditions that were not coercive. The Supreme Court reversed the decision, distinguishing between exclusions resulting from unnecessary delay and those resulting from involuntariness.[25] Holding that the case before it fell squarely within the *McNabb* ruling, the court emphasized that unnecessary delay alone was sufficient to cause exclusion of the confession.

That the *McNabb* test was not simply another test of voluntariness was reaffirmed in *Mallory v. United States.*[26] In *Mallory,* however, the Supreme Court amplified its previous holdings and established guidelines for the determination of what constitutes unnecessary delay.

The petitioner in *Mallory* was arrested in the early afternoon on suspicion of committing rape. He was given no warning that his statements could be used against him, nor was he told of his right to counsel. No attempt to take him before a magistrate was made until after he made a confession late that night. Although it stated that the "delay must not be of a nature to give opportunity for the extraction of a confession,"[27] the court recognized that the duty of arraignment "without unnecessary delay" indicated that Rule 5(a) did not command mechanical obedience. The *Mallory* Court alluded to three general categories of permissible delay: (a) delays for administrative reasons,[28] (b) delays induced by the suspect himself,[29] (c) delays caused by the inaccessibility of the magistrate.[30]

Reacting to outcries from law enforcement officials, judges and others, Congress passed the 1968 Omnibus Crime Control and Safe Streets Act which was intended to modify the *McNabb-Mallory* rule.[31] Title II, codified in 18 U.S.C. § 3501, established the legislative standard for the admissibility of confessions—namely, voluntariness.

Section 3501 (a) requires the trial judge to determine the voluntariness of the confession out of the presence of jury. If the confession is found to be voluntary, it will be admissible as evidence. To determine whether the confession

25 In the interim between *Mitchell* and *Upshaw,* Rule 5 became effective. In *Upshaw,* the Supreme Court applied its interpretation of the previous standard of "prompt arraignment" to the Rule 5 standard of "unnecessary delay."

26 354 U.S. 449 (1957).

27 *Id.* at 455.

28 *Id.* at 454. For example: transportation, booking, and other details usually out of the hands of the officer.

29 *Id.* at 455. For example: the volunteering of a story that can be readily checked.

30 *Id.* at 455. For example: an overnight arrest.

31 The courts themselves had begun to ameliorate the rule. By concentrating on the voluntariness of the confession in the absence of continuous psychological or physical coercion, and by allowing extended reasonable periods for interrogation, the courts undermined the *McNabb-Mallory* rule. After the *Miranda* decision, the emphasis on voluntariness became more pronounced as the federal courts felt that the mandatory warning sufficiently protected a suspect. This interpretation ran directly counter to the admonition of the Supreme Court in *Miranda* that the warning was not a substitute for the judicial warning given at the arraignment: "Our decision today does not indicate in any manner . . . that these rules [*McNabb-Mallory*] can be disregarded. When federal officials arrest an individual, they must as always comply with the dictates of the congressional legislation and the cases thereunder." *Id.* at 463.

is voluntary, subsection (b) provides that the trial judge is to consider all the circumstances surrounding the confession including (1) the delay between arrest and arraignment, (2) the defendant's knowledge of the nature of the offense with which he is charged or of which he is suspected at the time of confession, (3) whether the defendant knew of his right against self-incrimination, (4) whether the defendant was advised of his right to counsel prior to questioning, and (5) whether the defendant was without counsel at the time of questioning. The presence or absence of any of these factors is not to be conclusive on the issue of voluntariness.

Subsection (c) holds that a confession is not inadmissible solely because of delay in arraigning the defendant if three conditions are met: (1) the confession is found to be voluntary by the trial judge, (2) the weight to be given the confession is left to the jury, and (3) the confession was made within six hours of arrest. In addition to the conditions, subsection (c) contains a proviso stating that the six-hour limitation will not be applicable when the delay is found by the trial judge to be reasonable considering the means of transportation and distance to the nearest magistrate.

Subsection (c) also has implications for the working arrangement issue. In its discussion of delay, the section refers to a confession made while in custody of *any* law enforcement officer or agency. This portion of § 3501(c) has a direct bearing on the issue before the Seventh Circuit in *Gaines*.

The Working Arrangement

Utilizing the standards promulgated in the federal courts since *Anderson*, the Seventh Circuit in *Gaines* held that, in order to prevent admission of the confession, Gaines must prove the existence of a collusive working arrangement between federal and state authorities. The Seventh Circuit interpreted the district court statement of "very competent and able"[32] federal agents as contradictory to a finding of the existence of a working arrangement, but conceded that other facts, namely, the jail classification card, the police arrest sheet and the officer's testimony, created an inference of an improper working arrangement. Since "bare suspicion" is insufficient proof of a working arrangement, the Seventh Circuit reversed the suppression order and remanded for a more detailed finding on this issue.

Had the Seventh Circuit actually considered § 3501, however, it may have concluded that proof of a working arrangement is no longer required. Subsection (c) provides, in part:

> [I]n any criminal prosecution by the United States . . . a confession made or given by a person who is a defendant therein, while such person was under *arrest or other detention in the custody of any law enforcement officer or law enforcement agency,* shall not be inadmissible solely because of delay. . . .[33]

The language of subsection (c) would, on its face, appear to indicate that,

32 *See* 555 F.2d at 625.
33 18 U.S.C. § 3501 (emphasis added).

regardless of the amount of cooperation between state and federal officials, the time a suspect is held in state custody pending federal arrest must be considered in determining unnecessary delay.

The problem with this construction of this provision is that the statute itself is applicable only to federal prosecutions. Varying interpretations of the clause have arisen in those courts which have addressed the inconsistency—the clause has been held applicable both to federal detention alone[34] and to the combined federal and state detention.[35]

Under the first interpretation, the relevant delay is measured from the commencement of federal detention unless there is proof of a working arrangement between state and federal officials for the purpose of eliciting a confession. This interpretation seems to recognize that the statute is binding only on federal courts and should therefore apply only to federal officers and agencies. The potential of creating a type of silver platter, however, is immense. As evidenced in *Gaines,* state officials often violate required state procedures for prompt arraignment if the federal charge provides a harsher sanction.[36] Gaines had only been arrested on theft and shoplifting charges. The probability that the state police would have been able to hold him after arraignment on those charges was small. By failing to arraign Gaines, the police were able to detain him until federal officers could prefer charges. Thus the state officers are able to escape the consequences of their violation and the federal officers are able to elicit a confession with clean hands since the defendant was in state custody during the delay but was promptly arraigned on the federal charge after confessing.

The second interpretation was initially expounded in *United States v. Halbert.* In *Halbert,* the defendant was arrested by state officers for theft of an automobile and was subsequently charged with a violation of the Dyer Act.[37] Responding to Halbert's allegations that his confession should be suppressed because of unnecessary delay, the Ninth Circuit became the first court to construe § 3501.

In essence, the *Halbert* court interpreted § 3501 in such a way that all sections were considered part of the test of voluntariness. Delay, as outlined in subsection (c), became one of the factors in the determination of voluntariness under subsection (b) and was not accorded individual treatment as would result under the *McNabb-Mallory* rule.[38] In regard to the working arrangement issue, the Ninth Circuit specifically stated that, since its holding integrated subsection (c) into the voluntariness inquiry, it would assume that both state and federal

34 In United States v. Arcendiano, 371 F. Supp. 452 (D.C.N.J. 1974), the court stated, "It seems clear that only Federal custody is to be considered pertinent in the absence of a 'working relationship' between state authorities and Federal officers." United States v. Davis, 459 F.2d 167 (6th Cir. 1972).

35 436 F.2d at 1232. *See also* United States v. Hathorn, 451 F.2d 1337 (5th Cir. 1971); United States v. Johnson, 467 F.2d 630 (2d Cir. 1972).

36 On appeal, the government conceded that Gaines' detention for almost two days without taking him before a magistrate violated state law. *See also* Butterwood v. United States, 365 F.2d 380 (10th Cir. 1966), *cert. denied,* 385 U.S. 937 (1967) (no state charges ever lodged against the defendant).

37 18 U.S.C. § 2312 (1970).

38 *See* text accompanying note 47 *infra.*

custody was to be included in the determination of whether unnecessary delay negated the voluntariness of a confession.

In *Gaines,* the Seventh Circuit cited *Halbert* as a persuasive construction of § 3501. Although the reference to *Halbert* was in the context of the delay issue, the *Halbert* court's treatment of the working arrangement doctrine was a direct result of its interpretation of the delay issue. The Ninth Circuit's conclusion that all custody is relevant in the "delay" inquiry is inseparable from its ultimate decision that this delay is merely a part of the larger voluntariness question. In *Gaines,* the Seventh Circuit approvingly cited the *Halbert* view of delay, but neglected to consider that acceptance of the Ninth Circuit's reasoning might preclude the necessity of a "working arrangement" inquiry.

Unnecessary Delay

The *Gaines* court's failure to construe § 3501 also detracted from its discussion of the unnecessary delay issue. In citing *Halbert* as a persuasive construction of § 3501, the Seventh Circuit seemed to adopt the *Halbert* court's interpretation that delay was merely another factor to be considered by the trial judge in determining voluntariness. The district court in *Gaines,* however, had relied on another district court decision, *United States v. Erving,*[39] which specifically rejected the *Halbert* construction.

In *Erving,* the defendant had been arrested by city police for passing "raised" Federal Reserve notes. A federal officer arrived the following morning to interrogate Erving, who later confessed to the offense. At the hearing to determine the admissibility of this confession, Erving alleged that the approximately 11½-hour delay between arrest and arraignment before a federal magistrate was unnecessary and should in itself preclude the admission of his confession as evidence. The district judge found that the delay was unnecessary and that the court was not required to admit the confession even though it was nonfederal officers who were in control and who failed to take the defendant before a magistrate. Thus, unlike the *Halbert* construction in which the test for admissibility is strictly voluntariness, the *Erving* court required that the confession be voluntary and that it be obtained without unnecessary delay. Delay could, in itself, constitute grounds for exclusion. In attempting to distinguish *Erving,* the Seventh Circuit in *Gaines* noted that the *Erving* court did not require the exclusion of the confession but rather ordered further briefing regarding the exercise of discretion.

The *Gaines* court concluded that it need not decide which construction of the statute is more cogent because, "whatever the merits of the opposing approaches, we think it clear that a district court judge retains discretion to exclude a confession where there is a delay in excess of six hours."[40] In failing to actually construe the statute before concluding that both of the opposing approaches provide for discretion, the Seventh Circuit did not perceive that exercise of that judicial discretion could lead to opposite results, depending on the approach adopted.

39 388 F. Supp. 1011 (W.D. Wis. 1975).
40 *See* 555 F.2d at 623.

Halbert *Interpretation*

One approach, the approach taken in *Halbert,* is based totally upon the voluntariness of the confession and coincides with the legislative intent to make voluntariness the sole test for admissibility of a confession.[41] In determining the voluntariness of the confession under subsection (b), the trial judge is to exercise discretion in weighing five factors—delay in arraignment, knowledge of the nature of the offense charged, knowledge of the right against self-incrimination, knowledge of the right to an attorney and the presence of an attorney at questioning. The presence or absence of any of these factors is not to be conclusive on the issue of voluntariness.

Subsection (c) complicates this procedure because it provides for a separate review of delay in arraignment and couples the term "inadmissible"—not "involuntary"—with delay. The difference in terminology employed suggests that an independent review of delay was intended for purposes of determining admissibility when there was delay. Yet, the legislative history indicated that the sole test of admissibility was to be voluntariness. To reconcile this discrepancy, the *Halbert* court began with the premise that Congress did not intend that the subsection (c) test of delay abolish what it had just commanded in subsection (b), namely, that delay is only one factor in determining voluntariness.

Subsection (c) explicitly provides that confessions shall not be inadmissible solely because of delay in arraignment if three conditions are satisfied. It would seem from the language of the statute that a confession is inadmissible solely because of delay if the conditions are not met—a construction that clearly violates the legislative intent in drafting the statute and would be even more burdensome than the *McNabb-Mallory* rule. The *Halbert* court, realizing that this was not the legislative intent, noted that subsection (c) provided only that some confessions were to be admitted—all other confessions were not explicitly excluded. Based on its analysis of the legislative history, the court found that a per se exclusionary rule should not be implied when the conditions of subsection (c) are not satisfied. Instead, the *Halbert* court held that subsection (c), in providing that confessions were not inadmissible solely because of delay if they were otherwise voluntary and given within six hours of arrest (or within reasonable time if the proviso applied), merely limits the discretion which judges can exercise in considering delay as a factor of voluntariness under subsection (b). If the confession was made before six hours have elapsed, the confession is automatically admissible if otherwise voluntary. If there is a delay of over six hours occasioned by one of the reasons given in the proviso, such delay is to be treated as an excuse and thus the confession is again automatically admissible if otherwise voluntary. It must be

41 [1968] CODE CONG. & AD. NEWS 2282.
This title would restore the test for the admissibility of confessions in criminal cases to that time-tested and well-founded standard of voluntariness. It would avoid the inflexible rule of excluding such statements *solely* on technical ground such as delay or failure to warn the accused as to his rights to silence or to counsel. We have not nullified, however, the rights of defendants to the safeguards of federal law or the Constitution. On the contrary, we have provided a more reasonable rule in that the judge shall consider all the defendant's rights [speedy arraignment, silence, counsel, knowledge of offense charged] and their possible violation in deciding as to the voluntariness of the confession and thus its admissibility.

noted, however, that whether or not the reason for the delay constitutes a legitimate excuse remains a matter of judicial discretion. If the delay is over six hours without such an excuse, then and only then does the delay element become an issue to be considered under subsection (b) as one of the factors that determine voluntariness. This construction, according to the *Halbert* court, was consistent with the language of § 3501 and was a scheme under which the admissibility of the confession turned on voluntariness as intended by the legislature.

As even the *Halbert* court admitted, however, the integration is not perfect. The court said that the effect of subsection (c) was to remove "some of the discretion from the trial judge by requiring him to admit a confession, *otherwise* voluntary [and given within six hours of arrest]."[42] Thus, by the use of the term "otherwise" it seems the judge must determine whether the confession is voluntary weighing all the subsection (b) factors except delay, determine whether there was unnecessary delay under subsection (c), and, if there was, return to subsection (b) to redetermine voluntariness. Perhaps the problem, as previously noted, lies with the terms employed and the court's attempt to evade their literal meaning. The *Halbert* court equated admissible with voluntary and, because it afforded a convenient solution, equated inadmissible with involuntary. By equating terms that are not synonymous, the *Halbert* court avoided an acknowledgement that a confession could be "inadmissible solely because of delay" by making the delay, however inexcusable, merely one factor in the voluntariness inquiry. In reconsidering the voluntariness of the confession, the judge retains discretion to find the confession voluntary after weighing all of the factors.

Had the Seventh Circuit adopted the *Halbert* construction in *Gaines,* the delay between the arrest and arraignment would become a factor in determining the voluntariness of the confession as forty-six hours far exceeds the allowable six hours. None of the statutory excuses was applicable. Judicial discretion in this instance would be exercised not "to exclude a confession where there is a delay in excess of six hours,"[43] as the *Gaines* court suggested, but rather to determine the voluntariness of the confession, given that one of the factors is excessive delay. Since the presence or absence of any of the factors is not conclusive on the issue of voluntariness, it is probable that under the *Halbert* interpretation Gaines' confession would be held admissible.

This construction, however, does not accord with the judicial guidelines expounded by the Supreme Court in *Miranda* and *McNabb-Mallory.* The *Halbert* court assumes that "involuntary" and "inadmissible" are synonymous when in fact they are not.

Some courts have expanded this interpretation and held that a valid waiver of *Miranda* rights constitutes a waiver of prompt arraignment—the judicial waiving of rights.[44] In *Frazier v. United States,*[45] Judge (now Chief Justice) Burger warned that "[i]t is unsound to treat *Mallory* and *Miranda* as closely related; the former is a quantitative test of time delay, the latter is a qualitative test

42 *See* 436 F.2d at 1234 (emphasis added).
43 *See* 555 F.2d at 623.
44 United States v. Mandley, 502 F.2d 1103 (9th Cir. 1974); Frazier v. United States, 419 F.2d 1161 (D.C. Cir. 1969).
45 419 F.2d 1161 (D.C. Cir. 1969).

of the circumstances of the interrogation."[46] Thus, rights under *Miranda* (constitutional rights) and rights under *McNabb-Mallory* (procedural rights) should each be accorded its proper role.

Erving *Interpretation*

The double-edged judicial standard outlined by the Supreme Court decisions in *Miranda* and *McNabb-Mallory* is the construction given to the statute by the district judge in *Erving* and relied upon by the district judge in *Gaines*. Subsection (b) is regarded as the qualitative test of voluntariness based on *Miranda*.[47] Again, under this subsection the judge is to weigh all five factors to determine the voluntariness of the confession. The presence or absence of one will not be conclusive. The delay between arrest and arraignment can be one of the circumstances surrounding an interrogation to be considered in subsection (b): the longer the delay, the more likely that there was not a voluntary, intelligent waiver of rights.

If the trial judge concluded that the confession was voluntary under subsection (b), he would then proceed to subsection (c), which embodies the quantitative test of *McNabb-Mallory*. The statute deems a confession "not inadmissible solely because of delay" if the three conditions are met. If one of the three conditions is not met, the confession is inadmissible solely because of the delay.

The first condition, the determination of voluntariness by the trial judge, will have already been met by the time the judge addresses this section, as the test for voluntariness is embodied in subsection (b). If the confession is found to be involuntary, there is no need to address subsection (c) as the confession must be excluded. The second condition, the weight to be given the confession, will presumably be satisfied once the trial begins and the confession is entered into evidence for consideration by the jury. The third condition, the "six-hour test" is, again, the crux of the *Erving* interpretation.

If the confession was made within six hours after the arrest or detention, the judge has no discretion in deciding whether the delay was impermissible. If a delay was the result of one of the excuses described in the proviso, the confession would still be admissible without further consideration by the judge. Confessions made after six hours or confessions made after a reasonable allowance of time for one of the excuses enumerated in the proviso would be deemed inadmissible.[48]

Had the Seventh Circuit adopted the *Erving* construction in *Gaines,* the forty-six-hour delay between the arrest and the arraignment would preclude the admission of the confession as evidence. Judicial discretion would not be exercised "to exclude a confession where there is delay in excess of six hours"[49] as suggested

46 *See* 419 F.2d at 1171.
47 The constitutionality of this section is not addressed here.
48 This construction, in some respects, allows more leeway than the *McNabb-Mallory* rule. There is a six-hour grace period which *McNabb-Mallory* did not recognize. There is an automatic extension of the grace period when an excuse can be shown. This extension, however, is not to be interpreted as six hours to interrogate plus time required for transportation plus time required because of distance to the nearest magistrate. *See* 388 F. Supp. at 1018. The transportation or distance problem must cause the delay.
49 *See* 555 F.2d at 623.

by the *Gaines* court, because the statute requires exclusion after six hours or any additional amount of reasonable time due to an enumerated excuse. Judicial discretion in this instance could be used only to determine whether a reasonable excuse existed. Thus, under this interpretation, Gaines' confession would be voluntary yet inadmissible because of the unnecessary delay.

Conclusion

The Seventh Circuit failed to give guidance to the district court by neglecting to interpret § 3501 with regard to both the working arrangement issue and the delay issue. The court required Gaines to prove that the state custody was deliberately induced for the express purpose of eliciting a confession for federal purposes. The requirement that the working arrangement be proven seems to have been arrived at by default, as the court failed to address the applicable statutory clause indicating that detention by "any" officer is to be considered in determining whether there was unnecessary delay in taking Gaines before the magistrate.

If the district court concludes that a collusive working arrangement existed, the court must ascertain whether the confession is admissible. The district court, in its original order, felt bound to suppress the confession because of the excessive delay in bringing Gaines before a magistrate. The Seventh Circuit held that the judge retains discretion in determining whether to exclude the confession because of the delay, but failed to advise the district court as to whether the discretion is to determine delay within the context of voluntariness, or delay within the context of reasonable excuse. Although judicial discretion may depend upon a "congeries of factors, including such elements as the deterrent purpose of the exclusionary rule, the importance of judicial integrity, and the likelihood that admission of the evidence would encourage violations of the Fourth Amendment,"[50] the judge must know to what aspect of the delay issue that discretion is to be applied. Since the trial judge expressed doubt about the validity of his holding because of the ambiguity surrounding the delay issue, the Seventh Circuit, once it addressed the issue, should have provided guidance for the court. If the Seventh Circuit had fully considered § 3501, the court could have provided the needed framework in which to apply the discretion. Its failure to interpret the statute forces the judge to exercise that discretion without express guidance—the same posture in which he rendered his original decision.

Janet L. Miller

50 *Id.* at 623.

CONTEMPT—COMPETENCY OF COUNSEL—SENTENCING—THE FEDERAL GOVERNMENT MAY PROSECUTE OBSTRUCTIONS OF JUSTICE OCCURRING IN FULL VIEW OF THE COURT; ATTORNEY MISCONDUCT UNSUBSTANTIATED BY AFFIRMATIVE EVIDENCE MAY BE FOUND IF THE CONCLUSION IS "LOGICALLY COMPELLING"; A FEDERAL APPELLATE COURT MAY OVERTURN A SENTENCE IMPOSED WITHIN STATUTORY LIMITATIONS IF THE PROCESS BEHIND THE DECISION VIOLATED THE DEFENDANT'S SUBSTANTIVE OR PROCEDURAL RIGHTS.

*United States v. Harris**

In *United States v. Harris,* the Court of Appeals for the Seventh Circuit confronted complex questions concerning the judicial contempt power, standards of evidence, competency of counsel, and appellate review of sentences. Although the Seventh Circuit ultimately affirmed the appellant's conviction for intimidating a federal witness, the court ordered reconsideration of the sentence imposed by the trial court. In reaching this judgment, the court announced a number of principles that could have significant effects on future developments in criminal law.

On June 21, 1974, Jevita Hobbs appeared as a government witness in *United States v. Jeffers,*[1] a narcotics distribution conspiracy trial in the United States District Court for the Northern District of Indiana. During Ms. Hobbs's testimony, defendant Eugene Harris[2] rose from his chair and created a disturbance which caused the trial judge to order a recess. The court, however, did not invoke its power to cite Harris for contempt.[3] Subsequently, the government dropped the conspiracy charges against Harris but initiated the instant action in which Harris was charged with endeavoring to intimidate a federal witness.[4]

Four persons testified in the new case. Ms. Hobbs claimed that during her appearance at the *Jeffers* trial Harris stood up, shook his fist, and said, "You better not."[5] Ms. Hobbs added that she felt that this conduct had been an attempt to deter her testimony and that the incident so upset her that she needed the *Jeffers* trial recess to recover. Two law enforcement officers, one a special narcotics agent and the other a Deputy United States Marshall, basically cor-

* 558 F.2d 366 (1977).

1 520 F.2d 1256 (1975).

2 Ms. Hobbs was the former wife of a *Jeffers* defendant, and she apparently knew some of the other members of the alleged conspiracy. Harris had met her on several previous occasions at the apartment of his sister, who lived with Jeffers. The Seventh Circuit's opinion, however, does not indicate how this former association may have affected the behavior of either party in court.

3 18 U.S.C. § 401 (1970) provides:

> A court of the United States shall have power to punish by fine or imprisonment, at its discretion, such contempt of its authority, and none other, as —
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> (1) Misbehavior of any person in its presence or so near thereto as to obstruct the administration of justice;
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> (2) Misbehavior of any of its officers in their official transactions;
>
> (3) Disobedience or resistance to its lawful writ, process, order, rule, decree, or command.

4 18 U.S.C. § 1503 (1970) provides, in pertinent part: "Whoever . . . endeavors to influence, intimidate, or impede any witness, in any court of the United States or before any United States commissioner or other committing magistrate, . . . shall be fined not more than $5,000 or imprisoned not more than five years, or both."

5 558 F.2d at 369.

roborated Ms. Hobbs's testimony, although neither remembered that Harris had made a definite statement. The Deputy Marshall also said that the entire episode lasted about thirty seconds. Finally, the *Jeffers* trial judge recounted that he had noticed Harris rise, shake his fist, and move his lips in such a way as to disturb Ms. Hobbs. On cross-examination, he added that Harris's appearance "left the impression that [Harris] knew exactly what he was doing."[6] On this evidence, a jury convicted Harris of the crime charged.

As it weighed the appropriate penalty, the court received an official presentence Evaluative Summary prepared by a probation officer. This report proved quite favorable to Harris. It noted that although he had a limited criminal history,[7] his work record and cooperation with the authorities had been good. The court, however, received additional evidence. Another member of the Probation Department[8] submitted to the trial judge a document that contained unsupported accusations linking Harris to the organized drug trade. This second report, supported entirely by hearsay-on-hearsay statements,[9] concluded that since "the offense of intimidation of a Government Witness threatens the fiber of our criminal justice system," a person as dangerous as the defendant should, upon conviction, receive "the maximum sentence allowable under law."[10] The court ultimately concurred with the proposal of the latter report, and Harris received a five-year prison term, the maximum penalty. Significantly, Harris's attorney raised no objection to the propriety of the hearsay-on-hearsay accusations.

After enlisting the aid of a different lawyer, Harris sought relief from the Seventh Circuit. In her brief, the newly retained counsel argued four main points: (1) since Harris's conduct at the *Jeffers* trial occurred in the presence of the court, the government lacked authority to prosecute; (2) the evidence presented was insufficient to support conviction; (3) Harris had been denied his constitutional right to adequate trial counsel; and (4) the penalty imposed was based on prejudicial considerations.

The Applicability of 18 U.S.C. § 1503

Harris's first argument concerned the relationship of Federal Criminal Code §§ 1503 and 401(1). Relevant portions of the former criminalize intimidation of federal witnesses, whereas the latter provision delineates the power of courts to

6 *Id.* at 370.

7 Other than the charges related to the *Jeffers* trial, Harris's previous record included an armed robbery count subsequently reduced to theft, for which he served one year under supervision. Harris was also charged twice with assault and once with unlawful use of a weapon, all of which were eventually dismissed.

8 There is no fixed standard as to the number of probation officers involved in a particular case. FED. R. CRIM. P. 32, which provides for presentence reports, does not require a particular method of investigation. Also, in U.S. v. Conway, 296 F. Supp. 1284, 1285 (D.D.C. 1969), Judge Gerhard Gesell said, "A defendant has no vested right in the presentence report and does not have any say as to its preparation, its form or its use."

Policy apparently varies with different probation agencies. Some units split the investigatory and supervisory functions of a particular case among different personnel, whereas others combine them in a single officer. R. CARTER, CORRECTIONS IN AMERICA 171-83 (1975).

9 "Hearsay-on-hearsay" refers to testimony by a witness as to statements which he or she received as hearsay. The treatment of such statements in federal courts is contained in FED. R. EVID. § 805.

10 558 F.2d at 371-72 n.8.

punish summarily acts of contempt committed before them. Impeding a witness, like disrupting a trial, is an obstruction of justice.[11] Harris submitted that only a presiding judge has jurisdiction over such offenses occurring in his or her presence. Thus, Harris contended that the United States had no authority under § 1503 to prosecute him since his allegedly illegal conduct had taken place in court. In effect, this argument held that a federal trial judge's authority under § 401(1) to punish violations of judicial dignity and procedure totally preempts the government's ability to prosecute in-court contempts. The Seventh Circuit, however, dismissed the contention in three paragraphs.

The court first noted the principle, expounded in such decisions as *United States v. Ruggiero,*[12] that the government may prosecute under either of two statutes applicable to a defendant's criminal behavior. The Seventh Circuit then cited five precedents in support of its contentions that § 1503: (a) was applicable to in-court contempts and (b) should be a valid option for United States attorneys in cases such as *Harris.*[13] At no time, however, did the Seventh Circuit examine the legislative history of § 1503, other than to indicate that it did not support Harris's position. Public policy implications of the court's holding were also ignored. The entire thrust of the opinion was that the jurisdictional overlap of §§ 401(1) and 1503 was well-established.

The court's reasoning on the contempt issue contained several serious deficiencies. First, the principle that the government may act under either of two relevant criminal laws is inapplicable to *Harris.* The *Ruggiero* rule applies solely to instances that involve a selection of statutes both of which allow the government to prosecute. The summary contempt power of § 401(1), however, never figures in such options, because it can only be invoked by the federal courts and does not authorize actions brought by the United States. In *Harris,* the government could properly act only under § 1503. Therefore, the Seventh Circuit's invocation of the *Ruggiero* concept was unfounded.

Even more seriously, the court did not cite a single instance that involved a prosecution under § 1503 (or any of its prior versions) of a contempt committed before a sitting judge. Three of the precedents cited by the court involved incidents that occurred so far away from the courtroom that § 401(1) was clearly inapplicable.[14] The two remaining authorities, *Sharon v. Hill*[15] and *Savin,*

11 Annot., 20 A.L.R. Fed. 731, 734-42 (1974).

12 472 F.2d 599, 606 (2d Cir.), *cert. denied,* 412 U.S. 939 (1973). For this proposition, the Seventh Circuit also cited United States v. Zouras, 497 F.2d 1115, 1121 n.16 (1974).

13 Nye v. United States, 313 U.S. 33 (1941); Pettibone v. United States, 148 U.S. 197 (1893); Savin, Petitioner, 131 U.S. 267 (1889); United States v. Walasek, 527 F.2d 676 (3d Cir. 1975); and Sharon v. Hill, 24 F. 726 (C.C. Cal. 1885).

14 The cases in question included Nye v. United States, 313 U.S. at 33, which involved a contempt of court based on the defendants' attempt to gain an improper dismissal of a wrongful death action. The Supreme Court ruled that the contempt power was not applicable because the alleged offense had occurred more than 100 miles from the judge who issued the citation.

Pettibone v. United States, 148 U.S. at 197, also cited on this point, concerned use of the contempt authority to prevent unlawful approaches by the defendants to the servants of another.

United States v. Walasek, 527 F.2d at 676, discussed the destruction of evidence sought by a grand jury. Actually, the case involved the relationship of §§ 1503 and 401(3). *See* text accompanying notes 26-27 *infra.*

15 24 F. at 726.

Petitioner,[16] are also of questionable relevance. Both are old, decided in 1885 and 1889, respectively. Moreover, both decisions are distinguishable factually.

In *Sharon*, the defendant committed a violent contempt during an official sitting of chancery. No judge was present, and the presiding court examiner lacked authority to wield the contempt power. *Savin*, meanwhile, concerned illegal approaches made to a federal witness in a room and hallway adjacent to the courtroom. Neither *Sharon* nor *Savin*, therefore, supports the proposition that under § 1503 the United States has the authority to prosecute an act of contempt blatantly consummated in the presence of a federal judge sitting at trial and armed with the summary power of § 401(1). Indeed, the question is apparently one of first impression.[17]

Furthermore, by giving short shrift to the legislative history of the relevant statutes, the Seventh Circuit ignored a potentially powerful argument in Harris's favor. Sections 401(1) and 1503 share a common origin which dates to the early nineteenth century. At common law, English courts enjoyed a contempt power virtually unlimited in scope, which Congress codified for the federal judiciary in 1789.[18] Exercise of this broad prerogative led to several sensational cases and alleged abuses and contributed to extensive debate over the scope of the contempt power during the early years of the Republic. The controversy climaxed in 1830 with the impeachment and Senate Trial of James H. Peck, a federal judge from Missouri, who had imprisoned and disbarred an attorney for publishing criticism of a judicial opinion. Although Judge Peck was ultimately acquitted, the furor unleashed in Congress by his arbitrary behavior led to a strong drive for abridgment of the contempt power.[19]

On February 1, 1831, the House Judiciary Committee was "directed to inquire into the expediency of defining, by *statute*, all offenses which may be punishable as contempts of the courts of the United States, and also to limit punishment of the same."[20] Congress reacted swiftly to the proposal, and on March 2, 1831, President Jackson signed "An act declaratory of the contempts of court."[21] Section one of the new law limited the judiciary's summary power in a manner almost identical to the three parts of the modern § 401. The second section, moreover, mirrored the present version of § 1503 by granting the government authority to prosecute obstructions of justice related to the impeding of witnesses, jurors, or court officers in the discharge of their federal duties. The relevant provisions have changed little during the last century and a half.[22]

16 131 U.S. at 267.

17 *Harris* is apparently the first case in which the government brought an action under § 1503, or any of its predecessors, for an in-court contempt.

18 Section 17 of the Federal Judiciary Act of 1789 provided that "all the said courts of the United States shall have power to . . . punish by fine or imprisonment, at the discretion of said courts, all contempts of authority in any cause or hearing before the same." 1 Stat. 73, 83.

19 The controversy over the federal judiciary's summary contempt authority has a fascinating evolution closely intertwined with other political struggles of early American history. A good account, which includes the English and colonial origins of the concept, is in Nelles & King, *Contempt by Publication in the United States*, 28 COLUM. L. REV. 401 (1928).

20 Frankfurter & Landis, *Power of Congress Over Procedure in Criminal Contempts in "Inferior" Federal Courts—A Study in Separation of Powers*, 37 HARV. L. REV. 1010, 1026 (1924). This article contains a full transcript of relevant Congressional proceedings.

21 *Id.* at 1027.

22 The full text of the Act of March 2, 1831 is included in the Frankfurter & Landis essay. *Id.* at 1026-27.

Clearly, the Act of March 2, 1831 intended to limit the court's discretionary powers by divesting the trial judge of authority to punish most out-of-court contempts. Subsequently, such offenses would be subject to regular prosecution, with the defendant to enjoy the full range of procedural safeguards.[23] No evidence suggests, however, that Congress meant to give the government any prerogative over conduct within the purview of the trial court. Congress had no intention to infringe the judicial monopoly of regulating courtroom behavior. Accordingly, it is arguable that § 1503 and its antecedents were not designed to authorize prosecutors to initiate cases against in-court contempts, which remained under the exclusive jurisdiction of the federal bench.

Two recent decisions support this conclusion. In *United States v. Essex,*[24] which Harris cited, the Sixth Circuit held that "[s]ections 1 and 2 of the Act of March 2, 1831 are now part of our present statutory scheme as 18 U.S.C. § 401, which condemns obstructive acts in the court's presence, and 18 U.S.C. § 1503, which prohibits contemptuous conduct away from court, respectively."[25] Furthermore, *United States v. Walasek,*[26] a case surprisingly listed by the *Harris* court as a supporting precedent, contained the Third Circuit's solidarity with *Essex*: "The cases however are clear that § 1503 is also a contempt statute, derived from the same act of Congress as § 401, the legislative scheme being to divide contempts between those occurring in court (or very near to court) (§ 401), and those taking place away from court (§ 1503)."[27]

A final note on legislative history concerns a proposed reform of the federal contempt power offered by the Senate Judiciary Committee in 1975. This amendment would give the Attorney General, *with the consent of the trial judge,* authority to prosecute any in-court contempt of the type described in § 401. The language and provisions of this proposal are specific. That such an innovation has been presented and debated only strengthens the conclusion that Congress does not consider the present Federal Criminal Code to allow government attorneys to initiate cases based on in-court behavior.[28]

Thus, the Seventh Circuit's ruling on the relationship between §§ 401(1)

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23 This distinction between in-court and out-of-court contempts has extensive support in state law. For example, according to a California appellate court:

> In a direct contempt, that is a contempt in the immediate presence of the court, the judge in whose presence the contempt was committed possesses the constitutional power to punish the offender summarily. . . . Such power is necessary to preserve the integrity of the court. . . . But no such necessity exists in the case of an indirect or constructive contempt.

Turkington v. Municipal Court of the City and County of San Francisco, 85 Cal. App. 2d 631, 193 P.2d 795, 799 (1948).

New York follows California in this regard, stating that "criminal contempts fall into two classes, namely, one committed in the immediate view and presence of the court, and one committed out of court. The former is punishable summarily; and the latter only upon notification and reasonable opportunity to defend." People ex rel. Clark v. Truesdell, 79 N.Y.S. 2d 413, 415 (1948).

For a general treatment of state law on contempt, *see* Dobbs, *Contempt of Court: A Survey,* 56 CORNELL L. REV. 183 (1971).

24 407 F.2d 214 (6th Cir. 1969).

25 *Id.* at 217.

26 527 F.2d 676 (3d Cir. 1975).

27 *Id.* at 680.

28 This proposal was contained in S. 1, a potential overhaul of the entire Federal Criminal Code. As of this writing the bill is still before the Judiciary Committee, and its final form is uncertain. *See* S. 1, 94th Cong., 1st Sess. § 1331 (1975).

and 1503 is troubling. *Harris* is apparently the first decision in American history that grants the United States the right to prosecute individuals on the basis of their conduct during judicial proceedings. The opinion, however, included no detailed discussion of legislative intent, legal authorities, or public policy, as might be expected in such a major case. Rather, the court skirted these issues by incorrectly treating the question as settled. This result is particularly disconcerting when the potential impact of *Harris* on the criminal justice system is considered.

Theoretically, the trial court balances two equal adversaries, both of which are subject to its contempt power. Yet if authority to monitor courtroom conduct is shared with the government, the defendant's behavior will be reviewed not only by a judge who seeks to protect the administration of justice, but also by a potentially implacable foe wielding the options of prosecutorial discretion. This distinction concerns more than abstract jurisprudence.

The instant case demonstrates the potency of the new power conferred on United States attorneys by the Seventh Circuit. Harris was not convicted of any drug-related crime. The prosecution, however, had the prerogative to initiate a new action, based entirely on a thirty-second outburst in court. Upon conviction, moreover, Harris's sentence was heavily influenced by accusations related to the completed *Jeffers* trial. Thus, the Seventh Circuit not only allowed the government to prosecute the in-court contempt, but it also sanctioned punishment for the offense based on charges of which Harris had never been convicted.[29] The possible abuses of such a prosecutorial license are ominous, and the policy considerations deserve more attention than was afforded by the court.

This case could well become a premier precedent much cited by government lawyers exploiting new alternatives created by the Seventh Circuit's interpretation of § 1503. As such, *Harris* could deeply affect American criminal law. Thus, the court's inadequate treatment of the contempt issue is distressing.

The Evidentiary Requirements of § 1503

Harris's second argument was that his conviction was not supported by sufficient evidence. Harris claimed that his conduct at the *Jeffers* trial did not constitute a violation of § 1503 even if the court completely accepted the prosecution's version of the incident. The Seventh Circuit again treated the issue as determined by previous holdings.

From the outset, the court minimized the prosecution's evidentiary burden. The court referred to *United States v. Russell*,[30] in which the Supreme Court mandated that under § 135 of the Federal Criminal Code (an earlier form of § 1503), the "endeavor" element of the offense did not involve the strict definition of "attempt," but merely required "any effort or essay to accomplish the evil purpose that the section was enacted to prevent."[31] The Seventh Circuit also cited

29 A treatment of the types of factors a court may consider at sentencing is contained in the text accompanying notes 43-51 *infra*.

30 255 U.S. 138 (1921).

31 *Id.* at 143. *Russell* also has support in the Second, Sixth, and Ninth Circuits: United States v. Siegel, 152 F. Supp. 370, 373 (S.D.N.Y. 1957); Anderson v. United States, 215 F.2d 84, 87-88 (6th Cir. 1954); Kong v. United States, 216 F.2d 665, 667-68 (9th Cir. 1954).

In two more recent decisions, however, the "endeavor" requirement of § 1503 has been

United States v. Jackson[32] to support its conclusion that the *mens rea* component of a § 1503 offense can be proven circumstantially. Accordingly, the court concluded that Harris's conviction, although not based on "overwhelming"[33] evidence, could be affirmed under the principle of *Glasser v. United States;*[34] *i.e.,* that a federal appellate body will not overturn a conviction supported by "substantial"[35] evidence.

The facility with which the Seventh Circuit disposed of Harris's second contention did not give proper attention to the nature of the alleged offense. To violate § 1503, a person must have specific intent to obstruct the administration of justice. In *Jackson,* for example, there was ample evidence of the intimidation of a federal witness. The District of Columbia Circuit, however, remanded the case for a finding on the existence of a clear intent to prevent the victim from fulfilling his duty to testify.[36]

In the instant case, however, there were only two indicia of specific intent: Ms. Hobbs's belief that Harris had attempted to impede her testimony and the opinion of the *Jeffers* trial judge that Harris's appearance suggested that his courtroom misconduct had an underlying strategy. Apparently, Ms. Hobbs's interpretation of the incident rested in part on Harris's statement "You better not," which none of the other witnesses even heard. Moreover, the judge's suggestion that Harris "knew just what he was doing" was not part of the prosecution's case-in-chief, but instead was prompted by a clumsy cross-examination.[37] Nothing in the Seventh Circuit's opinion suggests how this evidence satisfied the *Glasser* "substantiality" test.

Harris's conduct at the *Jeffers* trial is easily explainable as a spontaneous eruption that lacked a rational intention, and hence as lacking the required *mens rea.* With conduct so innocuous, the prosecution should be required to present considerable circumstantial evidence to prove specific intent. Yet the government's case was at best negligible on this point. Furthermore, the Seventh Circuit has given no indication as to how a jury might construe such intent from the defendant's actions. Indeed, the concept of specific intent apparently was ignored. Such a cavalier treatment suggests a rolling back of the specific intent component of § 1503.

Furthermore, it is unclear that Harris's outbust, even if calculated to intimidate Ms. Hobbs, was a sufficient *actus reus* to justify an action under § 1503. The Seventh Circuit cited *United States v. De Stefano*[38] to support its position that to violate § 1503 a defendant need not succeed in deterring the witness, but need only act in such a way as would have a "reasonable tendency" to intimi-

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interpreted to require an overt act directed at a person who could affect the outcome of the case. Ethridge v. United States, 258 F.2d 234, 236 n.2 (9th Cir. 1958); United States v. Campbell, 350 F. Supp. 213, 214 (W.D. Pa. 1972).

32 513 F.2d 456, 461 (D.C. Cir. 1975).

33 558 F.2d at 370.

34 315 U.S. 60 (1942).

35 *Id.* at 80.

36 513 F.2d at 461. For a good treatment of § 1503's specific intent requirement, *see* Annot., 20 A.L.R. Fed. 731, 751-61 (1974).

37 558 F.2d at 370.

38 476 F.2d 324 (7th Cir. 1973).

date.[39] The latter case resembles *Harris* to the extent that the conduct in question also involved words and gestures. *De Stefano,* however, concerned an illegal approach made on an elevator to a potential witness in federal custody. Moreover, the defendants had underworld connections, and the victim received an implicit death threat. In contrast, when Ms. Hobbs was confronted with Harris's much more equivocal conduct, she was surrounded by the protections offered by the court, and she had already begun her testimony. Furthermore, nothing in their prior relationship suggests that Harris had any special personal influence over Ms. Hobbs. It is highly questionable that Harris's action, which did not even prompt sanctions from the *Jeffers* trial judge, had a "reasonable tendency" to intimidate. Unfortunately, the Seventh Circuit did not treat this question in any detail.

The total effect of this treatment of § 1503 is unclear. Although the impact of a single ruling, especially one that claims to conform to present case law, should not be exaggerated, *Harris* nevertheless provides precedent for upholding a § 1503 conviction based on negligible evidence of *mens rea* and *actus reus.* Thus, should other circuits adopt this decision, the safeguards available to a defendant charged with intimidation of a federal witness could be seriously impaired.

Competency of Counsel

Harris's third attack on his conviction consisted of a claim that he had been denied his sixth amendment right to counsel through his original lawyer's inadequate representation. Specifically, Harris's attorney argued on appeal that her predecessor had both failed to seek out favorable witnesses and committed grievous advocacy errors, as when on cross-examination of the *Jeffers* trial judge he had elicited statements favorable to the prosecution. According to the Seventh Circuit, a defendant can only prevail on a competency of counsel argument by showing that his or her attorney failed to meet a "minimum standard of professional representation."[40] This concept must be examined in order to evaluate Harris's third contention.

The Seventh Circuit's competency of counsel standard is rather new, dating to *United States ex rel. Williams v. Twomey,*[41] decided in 1975. Unfortunately, the ruling in *Twomey* was quite vague. The Seventh Circuit held that although reversal would not require that the original trial had been a sham, no presumption of constitutional irregularity would exist merely because counsel had made

39 *Id.* at 330.

40 Since the Supreme Court has never established comprehensive criteria for judging competency of counsel, each federal appellate jurisdiction has been relatively free to adopt its own. The First, Second, Fourth, Eighth, Ninth, and Tenth Circuits nominally adhere to the "farce" or "mockery of justice" standard, but there are many variations of this concept. The Third Circuit has adopted a malpractice norm of "normal competency." In the Fifth and Sixth Circuits, federal courts ask whether counsel was "relatively likely to render effective assistance." Finally, the District of Columbia's test is designed to determine if "reasonably competent assistance of an attorney acting as a diligent and conscientious advocate" was afforded the defendant.

These standards are compared in Annot., 26 A.L.R. Fed. 218, 239-57 (1976).

41 510 F.2d 634 (7th Cir. 1975).

"egregious errors, tactical or strategic."[42] The main amplification of the "minimum standard of professional representation" test, however, came during that same year in *Matthews v. United States,*[43] an opinion written by Judge (now Justice) Stevens. The facts of this case merit attention.

The *Matthews* defendants had been convicted of conspiracy to commit election fraud. On appeal, they charged their trial attorney with consulting each of them for less than one hour before trial and failing to produce any witnesses or evidence favorable to the defense. Judge Stevens, writing for the court, revealed two important aspects of the "minimum standard of professional representation." First, he stated that there exists a strong presumption that the original lawyer acted properly and that the defense can only overcome this burden by presenting affirmative evidence. Second, even if the trial attorney is shown to have been lax in a particular area, the defendant must show that this negligence resulted in material prejudice. For example, Judge Stevens explained that the appellants in *Matthews* not only had to allege that their erstwhile counsel did not find favorable witnesses, but also that such individuals existed and could have been identified by investigation.[44]

The Seventh Circuit ruled that Harris had failed to meet the requirements of the "minimum standard of professional representation" test, and this assertion appears correct. Harris's argument that his original counsel was lax in preparing and presenting his case lacked the affirmative evidence and proof of material prejudice demanded by *Matthews.* As later portions of the *Harris* opinion demonstrate, however, the "minimum standard of professional representation" test may in some cases be too strict even for the Seventh Circuit.[45]

Attack on the Sentence

Harris's last attempt to secure appellate relief was in the form of a plea for resentencing on the ground that his maximum prison term resulted from consideration of prejudicial evidence; *i.e.,* the hearsay-on-hearsay report. In response, the Seventh Circuit asserted that sentence review policy was well-established by a long line of cases. In *Dorszynski v. United States,*[46] for example, Chief Justice Burger explained that a federal appellate court must not interfere with a sentence imposed within statutory limitations merely because the penalty is considered unwise. Such decisions, the Chief Justice held, may only be overturned if an investigation of the sentence procedures reveals abuses or irregularities. Thus, although the Seventh Circuit admitted that Harris's five-year prison term was "excessive,"[47] it refused to intervene absent a showing that the sentencing procedures violated his substantive or procedural rights, both of which it proceeded to examine.[48]

42 *Id.* at 640.
43 518 F.2d 1245 (7th Cir. 1975).
44 *Id.* at 1246.
45 For further discussion of the potential effect of Harris upon the Seventh Circuit's competency of counsel standards, *see* text accompanying notes 55-65 *infra.*
46 418 U.S. 424, 431, 443 (1974).
47 558 F.2d at 372.
48 It should be noted that some jurists and scholars have argued that appellate review of sentences should have a much broader scope than that allowed in *Dorszynski. See, e.g.,* Smith v. United States, 273 F.2d 462, 468-69 (10th Cir. 1959) (Murrah, C. J., dissenting).

The Seventh Circuit noted that once a defendant is found guilty, a sentencing judge is not limited to considering evidence admissible at trial. Rather, the court may weigh a wide variety of information concerning the convict's problems, character, and criminal behavior, including unestablished accusations.[49] *Harris* in no way indicates that material of the type contained in the hearsay-on-hearsay report is per se improper.

Yet, as the Supreme Court ruled in *Townsend v. Burke*,[50] a sentence may not rest on assumptions concerning the defendant's prior record which are "materially untrue."[51] Moreover, in *United States v. Tucker*[52] the Court held that any penalty that explicitly relies on evidence deemed inadmissible for sentencing purposes must be remanded for reconsideration.

The *Harris* court indicated its willingness to dispense with the requirement of "explicit" reliance. Thus, the court stated that it would vacate a sentence based on improper evidence even if the trial judge had not clearly indicated that he had relied on such evidence in fashioning the penalty and would consider the totality of circumstances behind a sentence, of which the trial court's stated considerations would be only a part.

Existing precedent favored this expansion.[53] Furthermore, the court feared that rigid adherence to the *Tucker* standard might encourage judges to obscure the factors behind sentences in order to insulate their decisions from appellate review. Therefore, the success of Harris's attempt to obtain reconsideration of his five-year prison term depended on his ability to show that: (a) the hearsay-on-hearsay allegations were "materially untrue" and thus inadmissible for sentencing purposes, and (b) the trial court relied on the prejudicial accusations in arriving at the maximum penalty.

Nonetheless, this plea for sentence relief contained a potentially fatal defect. According to the Seventh Circuit, the cases holding that punishment may not hinge on inherently unreliable data had established a simple safeguard that allows the defendant to object to improper information in his or her presentence report.[54] Harris had apparently had this opportunity, and his original counsel had

49 *See* Farrow v. United States, 373 F. Supp. 113, 118 (S.D. Ca. 1974) ("Presentence reports are neither required to conform to the rules of evidence nor is their content restricted to established facts.") and Baker v. United States, 388 F.2d 931, 934 (4th Cir. 1968) ("Of course, the defendant's general conduct and behavior, as well as his reputation in the community in regard to honesty, rectitude and fulfillment of his civic and domestic responsibilities, may be treated in the [presentence] report.").

As the *Harris* court noted, some authorities contend that modern standards of penology, with attempts to fashion a penalty most suitable to the convict, actually render the use of such information humane. Note particularly Justice Black's opinion in Williams v. New York, 337 U.S. 241, 247-52 (1949). Of course, this position is invalid to the extent that one believes that "[T]he philosophy of confinement should be deterrence, accountability, and protection of society — not rehabilitation." W. E. Amos, *The Philosophy of Corrections: Revisited*, 38 FEDERAL PROBATION 43 (1974).

50 334 U.S. 736 (1948).

51 *Id.* at 740-41.

52 404 U.S. 443, 446-49 (1972).

53 McGee v. United States, 462 F.2d 243, 246-47 (2d Cir. 1972).

54 FED. R. CRIM. P. 32(c)(3)(A) grants the defendant and his or her counsel the right to inspect the presentence report exclusive of "any recommendation as to sentence, . . . diagnostic opinion which might seriously disrupt a program of rehabilitation, sources of information obtained upon a promise of confidentiality, or any other information which, if disclosed, might result in harm, physical or otherwise, to the defendant or other persons. . . ."

A review of considerations and issues behind such openness can be found in Gray, *Post*

never raised the appropriate challenges to the hearsay-on-hearsay statement. Thus, it is arguable that Harris waived the available procedural protection.

Nevertheless, the court, over a strong dissent by Judge Holder, ruled that although the waiver issue would ordinarily be critical, certain factors sufficiently distinguished this case to allow remand. First, the court held that Harris's original lawyer had apparently failed to read the presentence report. Significantly, this finding of misconduct[55] was not supported by affirmative evidence, as mandated by *Matthews*. Yet the majority claimed that failure of an attorney to object to the drug trade accusations after examining them would be "incredible,"[56] and thus the conclusion that Harris's counsel had failed to read the report was deemed "logically compelling."[57] Second, the "marked disparity"[58] between the official Evaluative Summary, which spoke favorably of Harris, and the uninvestigated claims of his underworld activities was held to deserve special consideration. Finally, the Seventh Circuit concluded that the hearsay-on-hearsay report had no "indicia of reliability."[59]

Accordingly, the Seventh Circuit ordered the five-year prison term vacated and the case remanded to the district court to allow Harris another opportunity to object to prejudicial evidence. The court added, "While the sentencing judge is free to reimpose the original sentence upon reconsideration, we are confident that he will give careful consideration to defendant's claim for sentence relief."[60]

Judge Holder's dissent deserves attention, because when juxtaposed with the majority opinion, it exposes additional uncertainties as to the effects of this case. The dissent essentially maintained that Harris's waiver of the right to object to the presentence report should have been decisive, because the factors considered by the majority as distinguishing *Harris* were based on pure speculation.

The dissent emphasized that the alleged failure of the original defense counsel to read the presentence report, a finding which weighed heavily with the majority, had no concrete evidentiary basis. Judge Holder even supposed that Harris's first attorney might have declined to object to the hearsay-on-hearsay document because the facts contained therein were true, and a challenge would therefore only have called attention to Harris's character. At any rate, the dissent argued that the majority erred in drawing such an inference of laxity without "factual support."[61] By presuming that the original lawyer had acted properly and requiring Harris to prove otherwise, Judge Holder undoubtedly con-

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Trial Discovery: Disclosure of the Presentence Investigation Report, 4 U. TOL. L. REV. 1 (1972).

55 Failure to read the presentence report is a clear violation of the American Bar Association's standards for defense counsel during the sentencing process. *See* ABA Advisory Committee on Sentencing and Review, *Standards Relating to Sentencing Alternatives and Procedures* 238-52 (1967).

56 558 F.2d at 376.

57 *Id.*

58 *Id.*

59 *Id.*

60 *Id.* at 377. Such a remand to the same district court which set the original penalty involves obvious problems of potential bias. If needed, remedy would probably involve a motion to remove the sentencing judge under 28 U.S.C. § 144 (1970). *See* Laughlin v. United States, 344 F.2d 187, 193-94 (D.C. Cir. 1965).

61 558 F.2d at 378.

formed more loyally to *Matthews* and the competency of counsel analysis in *Harris* than did the majority.

Furthermore, the dissent argued that the court erred in describing the relationship of the Evaluative Summary to the hearsay-on-hearsay report as one of "marked disparity." According to Judge Holder, since Harris could have maintained the facade of a good work record while covertly dealing in narcotics, the two documents were not necessarily contradictory. Finally, Judge Holder concluded that the majority also lacked sufficient evidence to support its contentions that the allegations of the second probation officer were baseless and that the district court, ostensibly well-trained in sentence procedure, improperly relied on prejudicial information.

A comparison of the majority and dissenting opinions raises a significant question as to the future of the Seventh Circuit's "minimum standard of professional representation." Clearly, an individual continues to enjoy the right to an attorney's assistance during the sentencing process. In *Mempa v. Rhay*,[62] Justice Marshall declared that "the necessity for the aid of counsel in marshaling the facts, introducing evidence of mitigating circumstances and in general aiding and assisting the defendant to present his case as to sentence is apparent."[63] Furthermore, such representation must adhere to the regular norms of competency. As the Supreme Court insisted in *McConnell v. Rhay*,[64] "[t]he right to counsel at sentencing must . . . be treated like the right to counsel at other stages of adjudication."[65]

The *Harris* majority, after following the *Matthews* formula in affirming the conviction, detoured sharply on the resentence order and required none of the affirmative evidence and proof of material prejudice usually required to find negligence of counsel. Moreover, there is no reason to conclude that this decision is limited to its facts or that the Seventh Circuit would not grant relief to another defendant who failed to satisfy the "minimum standard of legal representation" test, but whose competency of counsel argument was also "logically compelling." The early sections of *Harris* create several questionable precedents favorable to prosecutors. Yet defense attorneys might do well to test in future litigation the extent to which this case compromises *Matthews*.

A second question raised by a comparison of the majority and dissenting opinions concerns the Seventh Circuit's adherence to the Supreme Court's admonition in *Dorszynski* that a federal appellate court must not interfere with a sentence imposed within statutory limitations merely because the court considers

62 389 U.S. 128 (1967).

63 *Id.* at 135.

64 393 U.S. 2 (1968). There are no established standards for judging the adequacy of counsel during the sentencing process. Chief Judge Bazelon of the District of Columbia Circuit has said, "As of today, appellate courts may not know enough about sentencing to articulate clear and complete criteria as to what counsel's role must be." Bazelon, *The Defective Assistance of Counsel*, 42 U. CIN. L. REV. 1, 34 (1973).

According to the American Bar Association, a lawyer whose client is being sentenced has the professional duty to: (a) be familiar with the possible penalties, (b) keep the defendant informed of developments, (c) ascertain the factual basis of the punishment, and (d) generally present the "best possible case." ABA Advisory Committee on Sentencing and Review, *supra* n.55, at 238-52.

See also Portman, *The Defense Lawyer's New Role in the Sentencing Process*, 34 FEDERAL PROBATION 3 (1970).

65 *See* Portman, *supra* n.64 at 4.

the penalty unwise. In *Harris,* the court nominally accepted the *Dorszynski* concept but proceeded to dissect the judicial process behind the penalty so minutely that it is unlikely that any punishment deemed excessive could have withstood the examination. Currently, there is a strong reform movement that seeks to establish direct upper court review of penalties imposed by trial judges, even if within statutory limits. The Judicial Conference of the United States has considered several such innovations since the early 1970's, including the proposed Federal Rule of Criminal Procedure 35.1, which would allow appellate modification of "clearly unreasonable" sentences.[66] The latter amendment, after wide circulation by the Conference's Standing Committee on Rules of Practice and Procedure, has received widespread approval from the national bench and bar.[67] Furthermore, the Senate Judiciary Committee's proposed reform of the Federal Criminal Code in 1975 contained an almost identical provision.[68] The full effect of such debate on the Seventh Circuit cannot be fully measured, but *Harris* may well be a transitional case that signifies the demise of the *Dorszynski* rule before the official reform. If so, the court should clarify its policy.

Finally, the difference between the majority's maneuvers and the dissent's steadfastness raises the hidden question of equity. Harris was convicted under a statute which theretofore had never been applied to the type of offense that he allegedly committed. Moreover, the prosecution's case had been scanty, the original defense attorney may have been lax, and the maximum prison term may have arisen from unsubstantiated innuendo. Perhaps the majority's discontent with the five-year sentence encouraged it to bend Seventh Circuit standards of counsel adequacy and sentence review to modify Harris's punishment. If the court was willing to overlook sterile standards of court practice and procedure in order to do justice in this case, the result is laudable to the extent that it prevented Harris from serving five years in a federal prison for a thirty-second outburst. Nevertheless, failure to explain such a motive may well have further compromised the value of this case as a legal precedent.

Conclusion

In *United States v. Harris,* the Seventh Circuit rendered a decision that could easily cause difficulties in four major areas of criminal law. This opinion has subtly expanded the prerogatives of federal prosecutors and may enable them for the first time to monitor courtroom behavior. Second, the government's evidentiary burden on § 1503 cases could be sharply diminished if this ruling is followed in other jurisdictions. Finally, the court's statements on both competency of counsel and sentence review are clouded. *Harris*'s adequacy of representation ruling rigidly adheres to the *Matthews* standards. Conversely, later parts of the opinion make a clear finding of attorney misconduct supported by little, if any, affirmative evidence. Moreover, the same majority which claimed fealty to the *Dorszynski* rule vacated a prison term on the basis of similarly unproven assump-

66 Committee on Rules of Practice and Procedure of the Judicial Conference of the United States, Proposed Rule 35.1 of the Federal Rules of Criminal Procedure 1-3 (1976).
67 *Id.* at 3-9.
68 This proposal was contained in S. 1, 94th Cong. 1st Sess. § 3725 (1975).

tions. Thus, in the areas of competency of counsel and sentence review, *Harris* can be cited for contradictory conclusions.

The *Harris* mandates concerning both the government's right to prosecute in-court contempts and the evidentiary standards of § 1503 should be overruled, or at least fully relitigated. Each decision could be momentous, and neither received proper attention. Furthermore, the Seventh Circuit must clarify its criteria for sentencing and adequacy of counsel, in order that the continued efficacy of *Dorszynski* and *Matthews* can be determined. Such remedial action is required to prevent the subtle implications of *Harris* from adding confusion to the field of criminal law.

Frank Charles Sabatino

CRIMINAL LAW—CRIMINAL PROCEDURE—DEFENDANT'S RIGHT TO TRIAL BY AN IMPARTIAL JURY NOT VIOLATED BY TRIAL COURT'S MODIFIED *Allen* CHARGE IN CONJUNCTION WITH REPEATED POLLING OF THE JURY.

*United States ex rel. Anthony v. Sielaff**

The Constitution guarantees all criminal defendants the right to a trial by an impartial jury. Frequently, however, this right conflicts with the state's legitimate interest in the efficient administration of justice. This occurs when the jury has reached an impasse in its deliberations which may necessitate a retrial. In a number of decisions the Supreme Court has carefully defined the manner in which the court may intervene in such situations. Although the court may inquire into the possibility of agreement, its inquiry may not in any way coerce the jury.

In *United States ex rel. Anthony v. Sielaff* the Seventh Circuit also addressed this issue of jury coercion. It specifically focused on the question of whether the state trial judge's supplementary instructions in conjunction with repeated polling of the jury had a coercive effect on the jury's deliberations.

I. Statement of the Case

Defendant Anthony was tried on four counts of attempted murder. The charges stemmed from an attack made on four prison guards while Anthony was an inmate at the Illinois State Penitentiary. His sole defense on all counts was insanity. The first trial ended in a mistrial when the jury reported itself deadlocked after ten hours of deliberation. The retrial resulted in a verdict of guilty on two counts and not guilty on the other two counts.

Anthony appealed this conviction on the ground that the trial judge's conduct during the second trial constituted jury coercion. The challenged behavior involved a series of three communications between the judge and the jury during the jury's deliberations. In the first encounter, the judge denied a written request from the jury for a transcript of a witness' testimony. The second contact occurred after twelve hours of deliberation; the judge called the jury into open court and gave them a modified *Allen* instruction. The final interaction occurred one and one-half hours later when the judge again called the jury into court and polled the members to determine whether they were deadlocked. Eleven jurors indicated that there was no possibility of agreement. Nevertheless, one juror stated that the jury was not deadlocked and informed the judge that in his opinion the jury could reach a verdict. The judge again asked the jurors if they felt that they could reach a verdict with further deliberation, but the votes remained unchanged. The sole dissenting juror thereupon informed the judge that he thought that the jury could return a verdict in a half-hour. Once again the judge asked the jurors if they thought that they could arrive at a verdict by deliberating further. At this point eight jurors answered "yes," two stated that "they'd like to try," and two said "no." The judge then sent the jury back to the jury room. Twenty minutes later they delivered their verdict.

* 552 F.2d 588 (7th Cir. 1977).

The Illinois Appellate Court affirmed the conviction,[1] and the Illinois Supreme Court denied a subsequent petition for leave to appeal.[2] Anthony then filed a petition for a writ of habeas corpus in the United States District Court for the Northern District of Illinois, but his petition was dismissed. He appealed the dismissal to the Seventh Circuit. The court affirmed the dismissal on the ground that the facts did not support a jury coercion claim.

II. The Right to an Impartial Jury

The dilemma presented in *Anthony* arises from the need to balance two conflicting interests: the interest in safeguarding the defendant's constitutional guarantees to a "speedy and public trial by an impartial jury,"[3] and society's desire to obtain a just result while conserving judicial resources. These two factors conflict whenever a jury reaches an impasse in its deliberations. The trial judge must decide whether to grant a mistrial, which involves additional time, trouble, and expense for both the parties and the court, or to give the jury supplemental instructions to aid them in conscientiously reaching a unanimous verdict.

A. *Historical Background*

The judicial approach to the problem of the deadlocked jury has altered significantly as the courts have broadened their protection of the criminal defendant's constitutional rights to a fair trial by an impartial jury. The eighteenth century approach to this dilemma was that "the jurors should be kept without meat, drink, fire or candle . . . until they all unanimously agree."[4] There are many recorded instances in which courts have followed this rule and deprived jurors of various necessities of life until they reached some verdict.[5] As the courts began to overturn these blatant abuses, other more subtle judicial methods of extracting verdicts arose. These methods focused on mental coercion to overcome a jury impasse. Thus, jurors were advised of the added expense imposed on the court,[6] admonished for unnecessary use of the court's time,[7] and warned against further crowding the court's docket.[8] To curb the subtle coercion inherent in these instructions, yet still encourage deadlocked juries to reach a unanimous agreement, the courts adopted the practice of supplemental verdict-urging instructions. The majority of such instructions were derived from those sanctioned by the Supreme Court in *Allen v. United States*.[9]

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1 People v. Anthony, 30 Ill. App. 3d 464, 334 N.E.2d 208 (1975).
2 People v. Anthony, 61 Ill. 2d 598 (1975).
3 3 U.S. CONST. amend. VI.
4 IV BLACKSTONE'S COMMENTARIES 375 (1969).
5 *See, e.g.*, Mead v. City of Richland Center, 237 Wis. 537, 297 N.W. 419 (1941); Hancock v. Elam, 62 Tenn. 33 (1873); Pope v. State, 36 Miss. 121 (1858); Cole v. Swan, 4 Greene 32 (Iowa, 1853).
6 *See, e.g.*, Estes v. United States, 335 F.2d 609 (5th Cir. 1964).
7 *See, e.g.*, United States v. Kahaner, 317 F.2d 459 (2d Cir. 1963).
8 *See, e.g.*, Huffman v. United States, 297 F.2d 754 (5th Cir.), *cert. denied*, 370 U.S. 995 (1962).
9 164 U.S. 492 (1896). The *Allen* court's lengthy instructions provided, in pertinent part, that:

> [I]n a large proportion of cases absolute certainty could not be expected; that although

These so-called *Allen* charges have an essentially twofold nature. First, they admonish each juror to adhere to his conscientiously held opinions. Second, they urge the minority jurors to reconsider their opinions in light of the opinion of the majority. In addition, the charges usually stress the desirability of reaching a verdict and the economic waste of a retrial. They also point out the improbability of empanelling a more competent jury or acquiring more compelling evidence. There is a critical balance between these factors in the charges, and it is essential to the maintenance of this balance that the instructions emphasize the jurors' duty to adhere to their conscientiously held opinions.

Although the *Allen* charge initially enjoyed wide acceptance in the courts, a growing disenchantment with the use of the instruction has developed. This sentiment has arisen as a result of the recognized potential for coercion inherent in the admonition to the minority to reconsider their opinions in the light of the majority view. Dissatisfaction with this instruction led the American Bar Association in 1968 to draft an amendment to the *Allen* charge.[10]

The principal advantage of the instruction delineated by the ABA Standards is the critical balance obtained by asking each juror to reexamine his own views yet admonishing him not to surrender his honest convictions to the opinion of his fellow jurors. This explicit admonition is a safeguard against the potentially coercive effect of the charge. In addition, the ABA instructions, by providing that the jury may be discharged if no reasonable probability of agreement ap-

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the verdict must be the verdict of each individual juror, and not a mere acquiescence in the conclusion of his fellows, yet they should examine the question submitted with candor and with a proper regard and deference to the opinions of each other; that it was their duty to decide the case if they could conscientiously do so; that they should listen, with a disposition to be convinced, to each other's arguments; that, if much the larger number were for conviction, a dissenting juror should consider whether his doubt was a reasonable one which made no impression upon the minds of so many men, equally honest, equally intelligent with himself. If, upon the other hand, the majority was for acquittal, the minority ought to ask themselves whether they might not reasonably doubt the correctness of a judgment which was not concurred in by the majority.

Id. at 501.

10 American Bar Association Project on Minimum Standards For Criminal Justice, Trial by Jury, 145-46 (Approved Draft, 1968) [hereinafter cited as ABA Standards]:

Section 5.4 Length of Deliberations; Deadlocked Jury.

(a) Before the jury retires for deliberation, the court may give an instruction which informs the jury:

(i) that in order to return a verdict, each juror must agree thereto;

(ii) that jurors have a duty to consult with one another and to deliberate with a view to reaching an agreement, if it can be done without violence to individual judgment;

(iii) that each juror must decide the case for himself, but only after an impartial consideration of the evidence with his fellow jurors;

(iv) that in the course of deliberation, a juror should not hesitate to reexamine his own views and change his opinion if convinced it is erroneous; and

(v) that no juror should surrender his honest conviction as to the weight or effect of the evidence solely because of the opinion of his fellow jurors, or for the mere purpose of returning a verdict.

(b) If it appears to the court that the jury has been unable to agree, the court may require the jury to continue their deliberations and may give or repeat an instruction as provided in subsection (a). The court shall not require or threaten to require the jury to deliberate for an unreasonable length of time or for unreasonable intervals.

(c) The jury may be discharged without having agreed upon a verdict if it appears that there is no reasonable probability of agreement.

pears, specifically allow for the possibility that the jury will be unable to reach a verdict.

The current split in the federal courts regarding the use of the *Allen* charge reflects the courts' emerging concern with its coercive nature. The Seventh Circuit has rejected the charge outright, as have the District of Columbia and Third circuits.[11] The First, Eighth, and Tenth circuits have required modifications in the charge.[12] The remaining five circuits still permit its use.[13]

A number of state courts have also expressed their dissatisfaction with the *Allen* charge. Thus, ten state supreme courts have underscored the potential for jury coercion inherent in the charge by specifically disapproving it.[14] This shift in attitude reflects the growing conviction that supplementary judicial instructions given to a deadlocked jury may constitute an invasion of that body's exclusive domain of fact-finding.[15] It further reveals an increased concern in the courts for the potential psychological impact of these instructions on the jury.

B. *The Approach of the Seventh Circuit*

The Seventh Circuit first expressed its dissatisfaction with the *Allen* charge in *United States v. Brown.*[16] In *Brown,* the jury had been given the *Allen* charge over the objections of counsel. Although the Seventh Circuit rejected the defendant's jury coercion argument and affirmed his conviction, the court nevertheless ordered future compliance with the ABA Standards by the federal district courts within the Seventh Circuit.[17] The Seventh Circuit stated that the trial court should "charge deadlocked juries in both criminal and civil cases in a manner consistent with the recommended standards."[18] Nevertheless, the *Brown* court's use of the words "in a manner consistent" with ABA Standards unfortunately led to considerable litigation concerning the permissible limits of consistency.[19] To alleviate this confusion, the court utilized its supervisory powers in *United States v. Silvern*[20] and developed a required instruction for use by the

11 United States v. Thomas, 449 F.2d 1177 (D.C. Cir. 1971); United States v. Fioravanti, 412 F.2d 407 (3rd Cir.), *cert. denied,* 396 U.S. 837 (1969); United States v. Brown, 411 F.2d 930 (7th Cir. 1969), *cert. denied,* 396 U.S. 1017 (1970).

12 United States v. Flannery, 451 F.2d 880, 883 (1st Cir. 1971) (Both minority and majority must be urged to reconsider the other side's opinion, and the burden of proof instruction must be included); United States v. Pope, 415 F.2d 685 (8th Cir. 1969), *cert. denied,* 397 U.S. 950 (1970) (Both minority and majority must be urged to consider the other side's opinion); Burrup v. United States, 371 F.2d 556 (10th Cir.), *cert. denied,* 386 U.S. 1034 (1967) (Burden of proof instruction must be included).

13 United States v. Bailey, 480 F.2d 518 (5th Cir. 1973); United States v. Hynes, 424 F.2d 754 (2d Cir.), *cert. denied,* 399 U.S. 993 (1970); United States v. Sawyers, 423 F.2d 1335 (4th Cir. 1970); Sullivan v. United States, 414 F.2d 714 (9th Cir., 1969); United States v. Harris, 391 F.2d 348 (6th Cir.), *cert. denied,* 393 U.S. 874 (1968).

14 State v. Nicholson, 315 So.2d 639 (La. 1975); State v. Martin, 211 N.W.2d 765 (Minn. 1973); People v. Prim, 289 N.E.2d 601 (Ill. 1972), *cert. denied,* 412 U.S. 918 (1973); Fields v. State, 487 P.2d 831 (Alas. 1971); State v. Marsh, 490 P.2d 491 (Ore.), *cert. denied,* 406 U.S. 974 (1971); Commonwealth v. Spencer, 275 A.2d 299 (Penn. 1971); State v. Garza, 176 N.W.2d 664 (Neb. 1970); State v. Ferguson, 175 N.W.2d 57 (S. Dak. 1970); State v. Randall, 353 P.2d 1054 (Mont. 1960); State v. Thomas, 342 P.2d 197 (Ariz. 1959).

15 Huffman v. United States, 297 F.2d 754, 759 (5th Cir. 1962).

16 411 F.2d 930 (7th Cir. 1969), *cert. denied,* 396 U.S. 1017 (1970).

17 *See* text accompanying note 10 *supra.*

18 411 F.2d at 934.

19 *See, e.g.,* United States v. DeStefano, 476 F.2d 324 (7th Cir. 1973); United States v. Bambulas, 471 F.2d 501 (7th Cir. 1972).

20 484 F.2d 879 (7th Cir. 1973).

federal district courts in the Seventh Circuit whenever supplementary instructions were deemed necessary.[21] The court stated that if any instructions should thereafter deviate from those delineated in *Silvern,* the conviction would be reversed and the case remanded for a new trial.

III. Judicial Analysis of Jury Coercion

In considering supplementary jury instructions, two areas of contention arise. First, the language itself may be coercive. This typically occurs when the judge expresses a personal opinion in the case[22] or inquires into the numerical division of the jury during its deliberations.[23] Beyond mere language, however, the instruction may create an overall impression which is in itself coercive. Thus, in some cases the totality of circumstances may cause an otherwise inoffensive instruction to have a coercive effect on the jury's deliberations.

The issue of jury coercion frequently goes beyond the situation presented by an actual *Allen* instruction. Although the *Allen* charge presents one end of the spectrum of judicial coercion, more subtle forms of pressure on the jury present nearly identical threats to the principle of jury independence. The court's approach to these other forms of judicial jury coercion parallels that presented in their analysis of the *Allen* situation. The essence of this approach is the realization that although many justifications exist for encouraging a jury to reach a unanimous verdict, the court must scrupulously observe its paramount duty to preserve the accused's right to an impartial jury trial.

Implicit in this right is the right to a mistrial, for a hung jury constitutes one vital safeguard of a viable jury trial system.[24] The courts therefore uniformly hold that any verdict brought about by judicial coercion, regardless of its form, is invalid.[25]

The judicial practice of polling jurors during their deliberations is exactly the type of interaction which raises these concerns. Although jury polling is an acceptable exercise of judicial discretion,[26] the court must use extreme caution to guard against coercive overtones. The judge must strictly limit his inquiry to ascertaining whether the jury is hopelessly deadlocked. At no time should the judicial inquiry extend to the specifics of the jury's division.[27] The judge must

21 *Id.* at 882. The court held that the following instruction should be given:

> The verdict must represent the considered judgment of each juror. In order to return a verdict, it is necessary that each juror agree thereto. Your verdict must be unanimous.
>
> It is your duty, as jurors, to consult with one another and to deliberate with a view to reaching an agreement, if you can decide the case for yourself, but do so only after an impartial consideration of the evidence with your fellow jurors. In the course of your deliberations, do not hesitate to reexamine your own views and change your opinion if convinced it is erroneous. But do not surrender your honest conviction as to the weight or effect of evidence solely because of the opinion of your fellow jurors, or for the mere purpose of returning a verdict.
>
> You are not partisans. You are judges — judges of facts. Your sole interest is to ascertain the truth from the evidence in this case.

22 *See, e.g.,* Emmert v. State, 127 Ohio Rep. 235, 187 N.E. 862 (1933).

23 *See, e.g.,* United States v. Mack, 249 F.2d 321, 324 (7th Cir. 1957).

24 *See* note 15 *supra.*

25 Commonwealth v. Moore, 398 Pa. 198, 157 A.2d 65, 70 (1959).

26 *See, e.g.,* Carlton v. United States, 395 F.2d 10 (9th Cir.), *cert. denied,* 393 U.S. 1030 (1968).

27 *See, e.g.,* United States v. Mack, 249 F.2d 321, 324 (7th Cir., 1957).

also scrupulously refrain from expressing personal opinions concerning the proper disposition of the case.[28] The court must retain its posture of neutrality and detachment in order to preclude any improper influence on the jury. In elaborating this principle, the Court of Appeals for the District of Columbia Circuit stated in *United States v. Thomas*:[29] "When efforts to secure a verdict from a jury reach the point that a single juror may be coerced into surrendering views conscientiously entertained, the jury's province is invaded and the requirement of unanimity diluted."[30]

A fine line separates proper judicial guidance from improper coercion. It is imperative that the trial judge preserve the jury's independence by guarding against any prejudicial conduct. In determining whether particular conduct was coercive, an appellate court must consider all relevant facts and circumstances, including the nature of the contact, the timing, the apparent effect on the deliberation process, the weight of the evidence, and the nature of the verdict.

A. *The* Anthony *Rationale*

In *Anthony*, the Seventh Circuit analyzed the question of jury coercion in the light of the particular facts presented in the case. Ultimately, the court determined that the contact between the judge and jury in the trial court did not have a coercive effect on the jury's resolution of the charges.

The appeal focused on the jury polling conducted by the trial court. Anthony argued that the polling constituted supplementary instructions analogous to an *Allen* charge and that it was not tempered by a statement that admonished the jurors to adhere to their conscientiously held opinions. As previously noted, the critical balance necessary to a valid *Allen* charge is upset if this limitation is not stated.[31] Thus, Anthony argued that the omission of this limitation after the jury was polled constituted reversible error. Anthony contended that the repeated polling of the jury implied to the individual jurors that the judge believed that a unanimous verdict should be reached. By urging the jury to deliberate further, the trial judge exerted undue pressure on that body's independent processes. As a result, the verdict reached did not reflect an impartial adjudication by the jury. Rather, Anthony asserted that the jury had been swayed by the trial judge's insistence on reaching a verdict.

Various factors, emphasized in Judge Campbell's dissenting opinion,[32] support Anthony's position. First, nine jurors changed their opinion during the polling on whether they could reach a verdict. This shift of opinion occurred after the third jury poll, which supports Anthony's contention that the jurors were influenced by the trial judge's persistence. Second, the jury reached a verdict twenty minutes after the polling episode, despite its previous failure to agree after fourteen hours of deliberation. This factor is important in two respects. Initially, it appears incongruous that a jury, which eleven jurors had originally described

28 *See, e.g.*, Emmert v. State, 127 Ohio Rep. 235, 187 N.E. 862 (1933).
29 449 F.2d 1177 (D.C. Cir. 1971).
30 *Id.* at 1181.
31 *See, e.g.*, Moore v. United States, 345 F.2d 97 (D.C. Cir. 1965).
32 552 F.2d 588, 592 (7th Cir. 1977) (Anthony, J., dissenting).

as deadlocked, could suddenly reach a verdict within twenty minutes. Further, as the dissent emphasized, the sole juror to express the opinion that the jury was not hopelessly deadlocked stated during his discussion with the judge that a verdict could be reached in half an hour. It is likely, therefore, that the jurors believed that this half-hour constituted their deadline for reaching a verdict. Finally, both the appellant and the dissent argued that the verdict itself indicated a compromise. The four counts of murder with which Anthony was charged arose out of a fifteen-minute incident in which he attacked four prison guards. The elements of each count of the offense were identical; the sole defense on all counts was insanity. Therefore, it appears logically inconsistent to find the defendant guilty on the first two counts and not guilty on the remaining counts. Thus, Anthony argued that this verdict reflected the jury's belief that it was compelled to reach a verdict and was unable to agree unanimously on the disposition of all four counts. Therefore, the jury agreed on a compromise.

In response, the state argued that the polling of jurors was the routine practice of trial judges faced with a deadlocked jury. In considering this contention, the Seventh Circuit cited *Jenkins v. United States*,[33] which established the applicable test for evaluating the judge's charge to the jury. The Supreme Court in *Jenkins* stated that the reviewing court must determine whether "in its context and under all circumstances . . . [the polling] had a coercive effect."[34] The Seventh Circuit found that the judge's polling was noncoercive according to this test.

As the Seventh Circuit noted, the practice of polling jurors is proper as long as the inquiry is restricted to the prospect of reaching a verdict.[35] It must not inquire into the numerical division of the jury.[36] In addition, the polling must not unduly pressure the jurors to reach a unanimous verdict. In *Anthony,* none of the judge's remarks were of the sort traditionally categorized as coercive. Such remarks include those in which the judge tells the jury that they must reach a verdict,[37] or alludes to the cost of a retrial,[38] or sets a time limit on deliberation.[39] In *Anthony,* the inquiry was strictly confined to whether the jurors felt that they could reach a verdict.

The court also found that the polling was not analogous to an *Allen* charge in that the judge did not tell the jurors to reconsider their positions, to consult with one another, or to render a unanimous verdict. Rather, the court held that the communications strictly constituted a polling of the jury and as such were not coercive.

Finally, the court distinguished the two cases relied upon by Anthony. The petitioner cited *United States ex rel. Tobe v. Bensinger,*[40] in which the Seventh

33 380 U.S. 445 (1965).
34 *Id.* at 446.
35 Carlton v. United States, 395 F.2d 10 (9th Cir.), *cert. denied,* 393 U.S. 1030 (1968).
36 United States v. See, 505 F.2d 845, 851 (9th Cir.), *cert. denied,* 420 U.S. 992 (1974); United States v. Smoot, 463 F.2d 1221 (D.C. Cir. 1972); United States v. Mack, 249 F.2d 321, 324 (7th Cir. 1957), *cert. denied,* 356 U.S. 920 (1958); Brasfield v. United States, 272 U.S. 448 (1926).
37 Jenkins v. United States, 380 U.S. 445 (1965).
38 United States v. Taylor, 530 F.2d 49, 52 (5th Cir. 1976).
39 *Id.* at 51.
40 492 F.2d 232 (7th Cir. 1974).

Circuit found unconstitutional a statement made by the bailiff to the jurors during their deliberations instructing them that they must reach a verdict. This was held coercive, particularly in light of the fact that the statement was not tempered by an admonition to the jurors to adhere to their conscientiously held opinions. In *Anthony* the court distinguished this case on the ground that the statements challenged in that case were not only made outside counsel's presence but were also to the effect that the jury must reach a verdict. Such an instruction has consistently been held coercive.[41] In *United States v. Bass*,[42] also relied on by Anthony, supplementary instructions given in open court directed the jury to return and deliberate further on any count on which they had not yet reached unanimous verdict agreement. The Fifth Circuit held this instruction coercive on the ground that it virtually ordered the jury to reach a unanimous verdict. The Seventh Circuit distinguished the judicial contact with the jury in *Anthony* on the ground that the polling did not constitute the type of overt statement considered in *Bass*. On the contrary, the *Anthony* trial court merely inquired into the possibility of reaching a verdict.

B. *Analysis of the* Anthony *Decision*

The Seventh Circuit based its decision in *Anthony* primarily on the ground that jury polling is an accepted practice within certain defined bounds. The court held that by limiting his questions to the possibility of reaching a verdict, the trial judge remained within the permissible limits of this practice. Therefore, no reversible error occurred and the conviction was affirmed.

This analysis, however, effectively ignores the "totality of circumstances" aspect of the test for jury coercion which has been stressed repeatedly by the courts.[43] The mere fact that the words the judge used were not improper does not necessarily eliminate the possibility of coercion inherent in the overall situation in which they were delivered. In its decision, the Seventh Circuit focused on the actual polling process and overlooked the totality test. Application of this test necessitates an examination of the entire scope of the judicial interaction with the jury.

The judicial interaction in *Anthony* involved three distinct incidents. The first contact occurred when the judge denied the written request for access to a transcript of testimony. This is of little consequence in the analysis, particularly since there was no direct contact involved. Yet the second contact cannot be so lightly dismissed. After twelve hours of deliberation, the judge called the jury back into court and read them the modified *Allen* charge approved by the Seventh Circuit.[44] The effect of this instruction must be examined in considering the mental state of the jurors when they were later summoned back into court. The Seventh Circuit treated the jury polling as if it were detached from the rest of the deliberation process. This approach does not fairly represent the situation in the courtroom.

41 *See* note 37 *supra.*
42 490 F.2d 846 (5th Cir. 1974).
43 *See* note 33 *supra.*
44 *See* text accompanying note 21 *supra.*

The polling followed one and one-half hours after the *Allen*-type charge. The court held that the polling itself was not analogous to an *Allen* situation. In light of the previous *Allen* charge, however, this ruling appears erroneous. Each contact with the jury has an additive effect on the minds of the jurors. The court had already encouraged the jurors to deliberate further, to reexamine their own views, and to reach a verdict. They were already within the *Allen* frame of reference when the polling occurred. The multiple pollings which the judge then conducted necessarily had a high potential for unduly influencing the jurors. Their deliberations had already been affected by the overall direction implicit in the judge's instructions. Given the *Allen*-type instruction and the three separate pollings, the jurors should have been instructed again on their duty to follow their conscientiously held opinions in subsequent deliberation.

In applying the *Silvern* test[45] to these circumstances, the Seventh Circuit should have examined the overall effect of the judge/jury contact rather than merely the propriety of the component parts. It is true that the three contacts which the judge had with the jury, when considered independently of each other, were clearly within the scope of judicial discretion. Nevertheless, their additive effect arguably supports the opposite conclusion.

Thus, Anthony's reliance on *United States v. Bass*[46] appears to have been justified. By repeatedly polling the jury, the trial judge in *Anthony* achieved through implication the same result achieved through the judge's express statements in *Bass*. Both courts conveyed to the jury the message that they were to deliberate until they reached a unanimous verdict. Therefore, although *Bass* is distinguishable from *Anthony* on the grounds that the instructions in *Bass* were explicit, this distinction is meaningless. In both instances the impression on the jurors was coercive.

The verdict ultimately rendered in *Anthony* also supports the conclusion that the court's polling of the jury prejudicially affected its deliberations. The jury inconsistently found the defendant guilty on two counts and not guilty on the other counts. All four counts were identical, supported by essentially similar evidence, and defended in the same manner. The verdict reflected a compromise rather than a conscientiously rendered decision. This inconsistency is a significant indication that the jury felt compelled to compromise in order to return a verdict. The desire for a verdict is not a justification for judicial tampering with the deliberation process. The jury must be the impartial decider of facts; based on the facts, it deliberates in an effort to reach a unanimous verdict. If a verdict is reached, the case has been properly decided; if a verdict cannot be reached because the jury becomes hopelessly deadlocked, a mistrial is the appropriate result. The jury cannot be coerced or compelled to reach a verdict. The judge can instruct and advise them, but he cannot force them to a verdict. If he attempts to do so he has abridged the jury process and denied the defendant his constitutional right to a fair trial.

45 *See* text accompanying note 33 *supra.*
46 *See* text accompanying note 42 *supra.*

IV. Conclusion

It is impossible to analyze accurately the psychology of a jury, but the potential for jury coercion is objectively discernible. The fact that there were no blatant abuses of judicial discretion by the trial court in *Anthony* does not constitute a sufficient basis for affirming the decision. The subtleties of any case are critical and vary from case to case depending upon the particular circumstances involved. The court, however, must take a more flexible approach in its analysis of jury coercion that encompasses the totality of the circumstances. In *Anthony,* the constitutional bounds were inadvertently overstepped by the trial court's use of an *Allen*-type charge and its subsequent repeated polling of the jurors in an effort to prompt continued deliberation. The coercive effect of this course of action was clearly reflected in the logical inconsistency in the jury's verdict.

The Constitution guarantees all criminal defendants a fair trial. The right to an impartial jury is essential to that guarantee. If the independent processes of that body are abridged in any way, the defendant is effectively denied his constitutional right to a fair trial. Given the overriding importance of this right, any interference with it should be grounds for a reversal. In *Anthony* it is clear that the independent process of the jury had been tampered with in a subtle fashion. The verdict did not reflect a unanimous, independent jury decision. In light of this analysis, the Seventh Circuit's decision ignores the crucial psychological impact of repeated jury polling in favor of the desirability, from a juricial standpoint, of concluding every criminal trial with a verdict.

Kathleen M. Gallogly

CRIMINAL PROCEDURE—ENTRAPMENT DEFENSE REQUIRES ADMISSION OF OFFENSE PRIOR TO PLEA—A WIDE RANGE OF EVIDENCE IS INDICATIVE OF PREDISPOSITION—INFORMANT TESTIMONY NOT REQUIRED TO REBUT DEFENDANT'S CLAIM OF LACK OF PREDISPOSITION.

*United States v. Townsend**

In *United States v. Townsend*,[1] the Seventh Circuit considered the continually problematic defense of entrapment and its primary element, predisposition.[2] The majority of the court, in affirming Townsend's conviction for certain firearms offenses, demonstrated that the entrapment defense in the Seventh Circuit is one of extreme risk for a defendant. Of most significance, the court indicated that it will, as in the past, require the defendant's admission of the cirme alleged as a condition precedent to raising entrapment and that it will allow the admission of a wide range of evidence as indicia of the defendant's predisposition.

Johnathan Townsend delivered two sawed-off shotguns to an agent of the Illinois Bureau of Investigation on two separate occasions in January of 1974. As a result, he was charged with six counts of federal firearms regulations violations.[3] At trial, Townsend pleaded entrapment, contending that he had been induced to act by an informant hired by the Illinois Bureau of Investigation.[4]

The informant never appeared in trial to rebut the defendant's claim of inducement,[5] but the Government did introduce a variety of evidence purporting to show the defendant's predisposition to commit the offenses. The defendant was found guilty on four counts.[6] He appealed, alleging that he was not proven guilty beyond a reasonable doubt, that the evidence showed he was entrapped as a matter of law, and that the admission of certain prior convictions[7] into evidence was reversible error.

The majority, affirming Townsend's conviction, found that there was sufficient evidence to support the jury's decision that Townsend was predisposed to commit the offenses and therefore was not entrapped.[8] The majority also indicated that a wide range of evidence, including the defendant's prior convictions and his demeanor at trial, was relevant and admissible on the issue of predisposition.[9] The court also stated that there was no requirement that the Gov-

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* 555 F.2d 152 (7th Cir. 1977).

1 555 F.2d 152 (7th Cir. 1977).

2 "Predisposition" has become the touchstone of the subjective test of entrapment used in the federal courts. *See* note 21 *infra*.

3 555 F.2d at 153. Counts I and II charged knowing possession without payment of a manufacturing tax on January 24 and January 30, respectively. Counts III and IV charged possession without registration on January 24 and January 30, respectively. Counts V and VI, which charged knowing transfer of a firearm without payment of a making tax, were dismissed on the defendant's motion before trial.

4 *Id.* at 159 (Swygert, J., dissenting). The informant was unemployed and was paid on a case-by-case basis in payments ranging from $50 to $100 per case. The IBI had also promised to "speak up for him" in connection with other criminal charges pending against him.

5 *Id.* at 154.

6 *Id.* at 155.

7 *Id.* at 154.

8 *Id.* at 156.

9 *Id.*

ernment produce the informant's testimony to rebut the defendant's claim of improper governmental inducement.[10]

A dissenting judge argued that, while Townsend was not entrapped as a matter of law, due process required that the government introduce testimony from the paid informant.[11] The dissent also argued that much of the evidence the majority found as supportive of a finding of predisposition was not relevant because it was derived from the defendant's conduct during or subsequent to the offense.[12]

Unresolved Issues in the Entrapment Defense

The entrapment defense functions as a mechanism to relieve a defendant of criminal liability which is adjudged to have arisen from excessive governmental involvement with the criminal activity. The history of the defense in the federal courts has not been one of clarity or consistency.[13] The federal courts have had difficulty in articulating the basic perimeters of the defense, and the resulting uncertainty has engendered vigorous debate as to the rationale and practicality of the defense.[14] Since the recent United States Supreme Court's decisions in *United States v. Russell*[15] and *Hampton v. United States,*[16] however, there has been some stabilization of the doctrine. Cases such as *Townsend,* however, indicate the continuing practical problems encountered by defendants and courts trying to use the model of entrapment developed by the Supreme Court.

Federal courts are still developing rules to deal with three questions that arise whenever a defendant raises the entrapment defense: 1) must the defendant admit the crime alleged as a condition precedent to pleading entrapment; 2) what evidence is admissible to the issue of the defendant's predisposition; and, 3) when, if ever, is there entrapment as a matter of law? *Townsend,* directly or indirectly, addressed all of these issues and arrived at guidelines, particularly in respect to the admissibility of evidence, that should put any defense counsel in the Seventh Circuit on notice of the significant danger associated with the defense.

1. The Admission Requirement

Entrapment relieves the defendant of criminal liability even if all the ele-

10 *Id.*

11 *Id.* at 166 (Swygert, J., dissenting). "When a government informer for a fee supplies contraband and takes advantage of an ostensibly weak-willed but nondisposed 'friend' in the commission of a crime, due process demands that the prosecutor produce all the evidence available."

12 *Id.* at 162.

13 The courts have had difficulty in formulating a rationale for allowing a defendant who has committed all the essential elements of a crime to escape liability. The cases demonstrate that the courts are uneasy when confronted with governmental overinvolvement in criminal activity. That uneasiness has not, however, translated into a clear, workable doctrine.

14 *See* Murchison, *The Entrapment Defense in Federal Courts: Modern Developments,* 47 MISS. L.J. 573 (1976); Park, *The Entrapment Controversy,* 60 MINN. L. REV. 163 (1976); *Annot.,* 22 A.L.R. FED. 731 (1975); Hardy, *The Traps of Entrapment,* 3 AM. J. CRIM. L. 165 (1974).

15 411 U.S. 423 (1973).

16 425 U.S. 484 (1976).

ments of the crime are proved or admitted.[17] Because of this rather unique characteristic of the defense, the federal courts have addressed the issue as to whether, for the sake of logical consistency, a defendant must admit all the elements of the crime prior to raising the entrapment defense. Most of the circuits, including the Seventh Circuit, have adopted a "rule against inconsistent defenses" applying to the entrapment defense,[18] requiring such an admission. The issue is still far from settled, however, and is discussed later in this comment.

2. Admissibility of Evidence of Predisposition

Entrapment is a defense used almost exclusively in cases involving what have been called "victimless crimes." The enforcement of narcotics, alcohol, gambling, and sexual conduct laws appears to necessitate a certain amount of undercover government agent and informant activity.[19] The problem with such methods of law enforcement is that it is sometimes difficult to determine the genesis of the criminal activity. Although the defendant may have committed a criminal act, the defense often contends that the defendant would not have committed the crime had the government not prompted and aided him. That contention, and the government's response are the focus of the entrapment defense.

The dispute could be decided by looking primarily at the conduct of the government,[20] by looking primarily at the conduct of the defendant,[21] or by looking at a combination of these two factors.[22] The federal courts, particularly since

17 Entrapment varies from other affirmative defenses, such as insanity or duress, in that the defense of entrapment does not negate or vitiate any specific element of the offense. This, perhaps, accounts for the fact that there is generally no similar rule against inconsistent defenses when the other affirmative defenses are pled. *See* Tanford, *Entrapment: Guidelines for Counsel and the Courts,* 13 CRIM. L. BULL. 5, 18 (1977).

18 The proposition that denying the elements of a substantive offense and asserting entrapment are inconsistent is one of doubtful validity. For example, a defendant who had received contraband from a government agent and who was later charged with "knowing possession" could logically assert: 1. "I did not know the material was contraband." (substantive defense); and, 2. "The agent induced me to receive the material." (entrapment defense). *See* note 27 *infra.*

19 *See* Hardy, *supra* note 14, at 169, who offers the theory that the entrapment defense was a direct outgrowth of the enforcement of prohibition laws. *See also* Park, *supra* note 14, at 230, who gathered statistics which show that the entrapment defense is used almost exclusively by defendants accused of "consensual crimes."

20 This has been called the "objective test" and is most commonly associated with Justice Roberts' concurring opinion in Sorrells v. United States, 287 U.S. 435 (1932). It has had continued minority support in the Supreme Court and has received a great deal of support from the academic community. The test involves examining the conduct of the government to determine, as a matter of public policy, that the prosecution should be estopped. The evaluation is made by the court and the finding, if favorable to the defendant, is that entrapment exists as a matter of law.

21 This has been called the "subjective" or "predisposition" test and developed through the majority opinions in Sorrells v. United States, 287 U.S. 435 (1932) and Sherman v. United States, 356 U.S. 369 (1958), and was reaffirmed in *Russell,* 411 U.S. 423 and *Hampton,* 425 U.S. 484. The test involves examining the "predisposition" of the defendant to commit the type of offense charged. It is a thorough examination of the character and conduct of the defendant and presents difficult evidentiary problems. Under this test, entrapment is the quintessential jury question. The "subjective" test has been subject to considerable academic criticism. *See* Park, *supra* note 14 and Tandy, *supra* note 14, for contrasting views.

22 Although the objective and subjective tests are normally viewed as an expression of a governmental conduct-defendant's conduct dichotomy, the subjective test is actually a combined analysis of government conduct and the conduct and character of the defendant. Typically, there is a two part inquiry in the entrapment defense: (1) whether the offense charged was induced by government conduct, and (2) whether the defendant was predisposed to commit the type of offense charged. 356 U.S. at 369. The defendant first must show suf-

Russell and *Hampton,* have settled on an approach that looks almost exclusively at the conduct and character of the defendant. The central question concerning the defense is whether, prior to any governmental activity, the defendant was predisposed to commit the type of offense committed.

Because of this emphasis on predisposition, which is primarily a focus on the defendant's character and prior criminal activity, courts have been forced to determine the scope of evidence admissible on the issue. *Townsend* addressed this question at some length, arriving at some disturbing conclusions. These conclusions, and their implications, provide the primary focus for this comment.

3. Entrapment as a Matter of Law

Entrapment as a matter of law has also presented a problem to the federal courts. Entrapment as a matter of law is found when there is no disputed issue of fact as to the defendant's lack of predisposition.[23] In addition, although predisposition has been the touchstone of the entrapment defense for some time, until recently there was authority for finding entrapment as a matter of law because of governmental misconduct, even though the defendant's predisposition was established.[24] The theory behind this method of analysis has been explained both in terms of entrapment and due process, but its continued use has been placed in doubt by *Hampton.*[25]

Townsend addressed entrapment as a matter of law in a rather oblique manner. Both the dissent and the majority concluded that Townsend was not entrapped as a matter of law, but then went on to discuss at length cases specifically directed to that issue.[26] The majority did not state what would constitute lack of predisposition as a matter of law, but in discussing the broad range of evidence which it would construe as indicia of predisposition, the court severely limited the concept of entrapment as a matter of law.

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ficient governmental involvement with the offense to be entitled to an entrapment instruction, then the primary question becomes one of predisposition, the existence of which the prosecution must prove beyond a reasonable doubt. See notes 36-38 *infra.*

23 *Sherman,* 356 U.S. 369 and *Sorrells,* 287 U.S. 435.

24 United States v. West, 511 F.2d 1083 (3rd Cir. 1975); United States v. McGrath, 468 F.2d 1027 (7th Cir. 1972), *remanded* 412 U.S. 936 (1973), *modified* 494 F.2d 562 (7th Cir. 1974); United States v. Bueno, 447 F.2d 903 (5th Cir. 1971); Greene v. United States, 454 F.2d 783 (9th Cir. 1971).

25 The plurality in *Hampton* stated:

> In Russell we held that the statutory defense of entrapment was not available where it was conceded that a Government agent supplied a necessary ingredient in the manufacture of an illicit drug. We affirmed the principle of Sorrells v. United States, . . . , that the entrapment defense "focus [es] on the intent or predisposition of the defendant to commit the crime. . . . , rather than upon the conduct of the Government's agents. We ruled out the possibility that the defense of entrapment could *ever* be based upon governmental misconduct in a case, . . . where the predisposition of the defendant to commit the crime was established.

425 U.S. at 488-89 (emphasis added). This statement has caused some confusion. The concurring opinion in *Hampton* does not envision such a broad prohibition. "I therefore am unwilling to join the plurality in concluding that, no matter what the circumstances, neither due process principles nor our supervisory power could support a bar to conviction in any case where the Government is able to prove predisposition." 425 U.S. at 495 (Powell, J., concurring).

26 The dissent, 555 F.2d at 162-66 (Swygert, J., dissenting), cited *West* and *Bueno,* in which a defendant's unrebutted testimony showed entrapment as a matter of law as a result of impermissible governmental conduct. Judge Swygert attempted to analogize that the government had a similar burden to introduce the informant's testimony to rebut Townsend's testimony that he was not predisposed.

Townsend *on the Issues in Entrapment*

1. The Admission Requirement

The general rule among the circuits is that a defendant who relies on entrapment necessarily admits that he participated in the crime.[27] This has clearly been the rule in the Seventh Circuit.[28] If a defendant does try to raise the entrapment defense in conjunction with other defenses the courts can respond in a variety of ways. If a defendant tries, for example, to argue the sufficiency of the evidence of the substantive offense and to raise entrapment at the same time, the trial court can simply refuse to instruct the jury on entrapment.[29] At the appellate level, if the defendant raises entrapment along with other defenses the court may refuse to consider any of the defenses but entrapment.[30]

The rule has been uniformly criticized as forcing an unconscionable "election of defenses" on a criminal defendant. Due process arguments have been made claiming that the defendant must effectively surrender his presumption of innocence in order to raise the defense. Fifth amendment arguments have also been made on the theory that the defendant should not have to incriminate himself in order to raise a claim of entrapment.[31]

Although there is evidence of a movement in other circuits to relax the "rule against inconsistent defenses,"[32] the Seventh Circuit in *Townsend* gave no indication of a similar inclination. The rule is mentioned briefly in the *Townsend* dissent and not at all in the majority opinion. The dissent, while discussing predisposition, offhandedly stated that, "in order to assert an entrapment defense, a defendant must necessarily admit committing the crime."[33] Apparently the rule is so well established in the Seventh Circuit that even the dissent accepted it as a truism.[34]

2. Admissibility of Evidence of Predisposition

The predisposition, or subjective, test of entrapment entails a two-part inquiry: was the defendant induced to commit the offense by governmental conduct, and, was the defendant predisposed to commit the type of offense charged?[35] The defendant has the burden of going forward with evidence of inducement.[36]

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27 United States v. Mitchell, 514 F.2d 758 (6th Cir.), *cert. denied,* 423 U.S. 847 (1975); United States v. Rodriguez, 498 F.2d 302 (5th Cir. 1974); United States v. Watson, 498 F.2d 504 (3d Cir. 1974); United States v. Badici, 490 F.2d 296 (1st Cir. 1973); United States v. Smaldone, 484 F.2d 311 (10th Cir.), *cert. denied,* 415 U.S. 1079 (1973); United States v. Ramirez, 482 F.2d 807 (2d Cir.), *cert. denied,* 414 U.S. 1070 (1973).

28 United States v. Johnson, 426 F.2d 112, 114 (7th Cir. 1970).

29 *Id.* at 114.

30 Rowlett v. United States, 392 F.2d 438 (10th Cir. 1968).

31 *See* Tanford, *supra* note 17, and Groot, *The Serpent Beguiled Me and I (Without Scienter) Did Eat—Denial of Crime and the Entrapment Defense,* 1973 ILL. L.F. 254 (1973).

32 *See* United States v. Demma, 523 F.2d 981 (9th Cir. 1975), Hansford v. United States, 303 F.2d 219 (D.C. Cir. 1962).

33 555 F.2d at 162.

34 United States v. Johnson, 426 F.2d 112 (7th Cir. 1970); United States v. Roviaro, 379 F.2d 911 (7th Cir. 1967); United States v. Carter, 326 F.2d 351 (7th Cir. 1963).

35 356 U.S. at 373.

36 A defendant can raise entrapment by showing evidence of (1) inducement or corruption by government agents; or (2) participation in the criminal enterprise by government agents; or (3) instigation of the criminal design by the agents; or (4) government

If the defendant introduces sufficient evidence of inducement,[37] then the burden of proof shifts to the government, which must then show beyond a reasonable doubt that there was no entrapment.[38] Although the government can challenge the defendant's evidence of inducement, the typical approach is to rebut the defendant's claim of entrapment by introducing evidence of the defendant's predisposition to commit the offense.[39] The problem lies in determining the permissible scope of the inquiry into the defendant's character and conduct.

In *Sorrells v. United States,* Chief Justice Hughes stated that, "If the defendant seeks acquittal by means of entrapment he cannot complain of an appropriate and searching inquiry into his conduct and predisposition upon that issue. If in consequence he suffers a disadvantage, he has brought it upon himself by reason of the nature of the defense."[40] Since then the federal courts have used Chief Justice Hughes' rationale to justify the admission of a wide range of evidence that would normally be inadmissible, on the theory that this evidence is relevant to proof of predisposition and that a "searching inquiry" is appropriate. *Townsend* demonstrates that the Seventh Circuit has adopted an unrestrictive view of the admissibility of evidence purporting to show predisposition. Of more importance, *Townsend* shows that the Seventh Circuit will view a wider range of evidence as indicia of predisposition.

Several matters are relatively well settled concerning the admissibility of predisposition evidence. Prior convictions based on similar conduct are admissible, but their presence or absence is not conclusive.[41] Evidence of misconduct other than convictions, such as prior arrests, has been freely admitted even when the conduct took place subsequent to the offense charged.[42]

In addition to these settled areas, federal courts have allowed the admission of rather questionable evidence. Courts have allowed agents or informers to testify about a defendant's unpunished criminal acts, including those not resulting in arrest, regardless of how incredible the testimony appeared to be, as long as there was some corroboration.[43] Agents have been allowed to testify about mat-

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provision of the contraband for possession of which the defendant was charged. *See, e.g.* United States v. Doe, 486 F.2d 892 (5th Cir. 1973); United States v. Test, 486 F.2d 922 (10th Cir. 1973); United States v. DeVore, 423 F.2d 1069 (4th Cir. 1970), *cert. denied,* 402 U.S. 950 (1971); United States v. Bueno, 447 F.2d 903 (5th Cir. 1971).

37 Courts appear to be changing from a rule in which the defendant has to show inducement to a preponderance to a rule in which the defendant only has the burden of going forward. *See, e.g.,* Kadis v. United States, 373 F.2d 370 (1st Cir. 1967).

38 United States v. Silver, 457 F.2d 1217 (3d Cir. 1972).

39 Three of the basic ways to show predisposition are: (1) proof of a course of similar conduct; (2) proof of an existing criminal intent; and (3) proof of a willingness, lack of resistance, or a ready response to a criminal suggestion. *See, e.g.,* United States v. Reynoso-Ulloa, 548 F.2d 1329, 1336 (9th Cir. 1977); United States v. Anglada, 524 F.2d 296, 290 (2d Cir. 1975).

40 287 U.S. at 451.

41 United States v. Dickens, 524 F.2d 441, 445 (5th Cir. 1975); United States v. Perez, 493 F.2d 1339, 1344 (10th Cir. 1974); United States v. Tyson, 470 F.2d 381, 381 (D.C. Cir.), *cert. denied,* 410 U.S. 985 (1973).

42 United States v. Rodriguez, 474 F.2d 587 (5th Cir. 1973); United States v. Principe, 482 F.2d 60 (1st Cir. 1973); Pulido v. United States, 425 F.2d 1391 (9th Cir. 1970).

43 United States v. Brown, 453 F.2d 101 (8th Cir. 1971); United States v. Cooper, 321 F.2d 456 (6th Cir. 1962).

ters they have witnessed which did not amount to a crime.[44] Hearsay evidence has been admitted in a variety of situations.[45] In some cases, the government has been allowed to introduce evidence of unrelated criminal activity to show that an accused had a general criminal propensity.[46]

The question of admissibility is bound up with the underlying question of probative value. It is not clear exactly what evidence demonstrates the existence of predisposition. Logically, predisposition would appear to be essentially an *a priori* concept, in which the only relevant evidence would be that relating to the defendant's conduct and character as they existed before the crime alleged. Such, however, is not the case. The defendant's actions while committing the crime at issue have been held relevant to the issue of predisposition, on the theory that the actions can demonstrate a willingness to engage in crime which, in itself, is a strong indication of predisposition.[47] As stated earlier, some courts view subsequent conduct as relevant to the issue of predisposition.[48]

Judge Swygert, in his dissent in *Townsend,* adopted a restrictive view of the relevance, and presumably the admissibility, of the evidence of Townsend's prior criminal activity. Judge Swygert argued that Townsend's prior arrests while in possession of firearms and his prior arrest for armed robbery were not relevant to the issue of the defendant's predisposition to sell or deal in sawed-off shotguns.[49]

Judge Swygert also addressed the issue of whether evidence of the commission of the crime alleged was relevant to a determination of the existence of predisposition. His analysis indicates that he views the question of predisposition as an exclusively *a priori* issue:

> The actions described by the majority as evidencing predisposition were all either part of the commission of the crime or immediately preparatory to its commission. Townsend's contention is not that he did not aid in the sale of the guns: this, obviously, cannot be so if he claims entrapment. Townsend contends merely that before Core importuned and tricked him into making the sale, he had no predisposition to sell illegal firearms. Thus, the critical time frame for predisposition evidence, misapprehended by the majority opinion, is the time immediately prior to the IBI's solicitation of the defendant and not during the crime's commission.[50]

44 In a drug sales prosecution, government agents were permitted to testify that they had seen a "roach clip" of the type used for smoking marijuana in an ashtray in the defendant's apartment. United States v. Tyson, 470 F.2d 381. (D.C. Cir.), *cert. denied,* 410 U.S. 985 (1973).

45 In United States v. Fink, 502 F.2d 1 (5th Cir. 1974), *cert. denied,* 421 U.S. 911 (1975) the court allowed a federal agent to testify concerning the defendant's reputation when the sole basis for the testimony was the agent's inspection of local police files. *See also* Rocha v. United States, 401 F.2d 529 (5th Cir. 1968), *cert. denied,* 393 U.S. 1103 (1969).

46 United States v. Hawke, 505 F.2d 817 (10th Cir. 1974); Robinson v. United States, 379 F.2d 338 (9th Cir. 1967).

47 This rationale has been used to justify a finding of predisposition in cases in which the defendant had no prior history of criminal activity and the government agents had no reason to suspect the defendant was engaged in criminal activity prior to their solicitation. For an extreme example, *see* United States v. Ordner, 554 F.2d 24 (2d Cir.), *cert denied,* 46 U.S.L.W. 3192 (U.S. Oct. 3, 1977).

48 United States v. Rodriguez, 474 F.2d 587.

49 555 F.2d at 161.

50 *Id.* at 162.

According to this view, the only evidence relevant to predisposition is evidence of pre-crime activity.

The majority in *Townsend* did not subscribe to such a narrow view of the relevance and admissibility of evidence offered to show predisposition. The majority found that there was a variety of evidence from which the jury could find predisposition. It cited approvingly the government's summary of the evidence of predisposition:

> 1. Townsend was charged with the possession of two firearms on two different occasions.
> 2. He had been involved in an armed robbery.
> 3. He was knowledgeable as to firearms.[51]
> 4. He had been arrested a number of times with a firearm.
> 5. He had the first gun (a sawed-off shotgun) two or three days before selling it to Warren instead of getting rid of it.
> 6. Defendant could have called informant Core as a witness if he considered Warren's testimony was false.[52]
> 7. He admitted he shared in the sale proceeds.
> 8. He did not deny having seen the first weapon "before in his life" in contrast to the second weapon (also an illegal sawed-off shotgun).[53]

The majority also approved the introduction of evidence of a conviction received by the defendant more than ten years prior to the offense currently charged.[54]

It is apparent that the majority was willing to allow a wide range of evidence to go to the jury and to construe an equally wide range of evidence as indicative of predisposition. The court found that previous convictions and arrests involving firearms were relevant and admissible, even if some of the convictions were over ten years old. The court also endorsed the policy that evidence of the crime charged can be probative of the defendant's predisposition to commit the crime.

A potentially significant proposition advanced by the majority was its statement that the defendant's conduct at trial was probative of his predisposition to commit the offense for which he was being tried. This is a dubious extension of the meaning of the term predisposition. In a footnote, the majority casually addressed the defendant's demeanor at trial while explaining its rationale for rejecting an *a priori* analysis of predisposition:

> The dissent asserts that the existence or nonexistence of predisposition is to be determined during the time period before the crime is completed. We, of course, agree. However, probative evidence of predisposition is not

51 In these days of the ubiquitous firearm, the logic of imputing predisposition from a knowledge of firearms is questionable.

52 Again, the court indicates that predisposition can be evidenced by defense counsel's tactical considerations at trial.

53 555 F.2d at 156.

54 FED. R. EVID. 609 (b) provides in part:

> Evidence of a conviction under this rule is not admissible if a period of more than ten years has elapsed since the date of the conviction . . . , unless the court determines, in the interests of justice, that the probative value of the conviction supported by specific facts and circumstances substantially outweighs its prejudicial effect. . . .

The court found that, even though Rule 609 (b) had not yet become effective at the time of Townsend's trial, the trial judge's action in allowing the admission of the old conviction would have met the test of Rule 609 (b).
555 F.2d at 158.

> rigorously confined to an *a priori* time frame. Surely the demeanor (as distinguished from the substantive testimony) of the defendant on the stand, although adduced after the crime, is direct, probative evidence going to the existence or nonexistence of predisposition. Similarly, the enthusiasm and initiative shown by the putatively entrapped defendant in the crime also can relate back to the *a priori* time frame. The resolution of these subtle factual issues is at the very heart of the traditional function of the jury.[55]

The soundness of the proposition that a defendant's trial demeanor can be direct indicia of predisposition is questionable. Perhaps the court would have been on firmer ground if it had said that the defendant's demeanor could have an effect on his credibility which could, in turn, affect the weight of his testimony that he was not predisposed. That, however, is not what the majority said. The majority plainly stated, albeit in a footnote, that demeanor testimony occurring subsequent to the crime charged could be direct evidence going to the existence of predisposition.[56]

3. Entrapment as a Matter of Law

Entrapment as a matter of law in the federal courts has been based on either of two rationales: 1) cases in which the defendant's lack of predisposition is established and unrebutted;[57] and, 2) those when governmental activity is impermissibly involved with the criminal activity.[58]

Sherman v. United States[59] and *Masciale v. United States*[60] were companion cases decided on the same day by the United States Supreme Court and, presumably were issued together to demonstrate, utilizing the predisposition test, the difference between entrapment as a matter of law and entrapment as an issue of fact. In *Sherman* the defendant moved for acquittal on the grounds of entrapment at the close of the government's case-in-chief. The Court found that the government's evidence, by itself, provided enough evidence of inducement and lack of predisposition to warrant a finding of entrapment.[61]

In *Masciale,* the government's case-in-chief indicated that the defendant had been "ready and willing to search out a source of narcotics and to bring about a sale."[62] This, in itself, was evidence indicating possible existence of predisposition. To rebut this inference the defendant testified that he had been persuaded by a government informant to commit the crime. Although the defendant's testimony of inducement and lack of predisposition was unrebutted, the court found that an issue of fact existed concerning predisposition as a result of the evidence of the defendant's willing cooperation with the informant. Because there was an issue of fact, there could not be entrapment as a matter of law.

55 555 F.2d at 157 n.8.
56 The majority in two other instances note defense counsel or the defendant's conduct at trial as possibly being relevant to the issue of the defendant's predisposition. Again, the proposition that trial tactics or inadvertent remarks by counsel during closing argument can constitute indicia of predisposition is questionable. *Id.* at 156, 158 n.9.
57 *See* 287 U.S. 435 and 356 U.S. 369 for examples of the traditional test of entrapment.
58 *See* note 24 *supra.*
59 *See* note 21 *supra.*
60 356 U.S. 386 (1958).
61 *Id.* at 373.
62 *Id.* at 388.

In *United States v. Spain,* the Seventh Circuit followed a similar analysis. In affirming a conviction over an entrapment defense, the court concluded that "Entrapment is established as a matter of law only when the absence of predisposition appears from uncontradicted evidence. In the case at bar the evidence bearing on the issue of predisposition was in conflict, and that issue was therefore properly submitted to the jury. . . ."[63] The test, then, in the Seventh Circuit and in other circuits[64] is that there can be no finding of entrapment as a matter of law when there is an issue of fact as to the defendant's predisposition. The question then arises as to what types of evidence can create an issue of fact sufficient to eliminate entrapment as a matter of law. *Townsend* has particular relevance to this question.

As previously mentioned, *Townsend* indicates that the Seventh Circuit has construed a broad range of evidence as indicative of predisposition. Old convictions and, perhaps, even the defendant's conduct at trial can demonstrate predisposition. If this is so, it appears that there will be few, if any, instances in which there will be no evidence of a defendant's predisposition. In short, the more evidence the court is willing to construe as evidence of predisposition, the more likely it is that some evidence will be present in any particular case that can support the finding that a disputed issue of fact exists. Virtually every entrapment case will pose an issue for the jury because lack of predisposition will be almost impossible to establish as a matter of law.

A brief comparison of *Townsend* with *Sherman* provides a helpful illustration. In *Sherman* the defendant had a nine-year-old conviction on his record, but the court found that the conviction was not evidence of predisposition sufficient to create an issue of fact.[65] The *Townsend* court, however, apparently would view such a conviction as creating an issue of fact and, therefore, could not find entrapment as a matter of law.[66] It appears that entrapment will, except in the rarest circumstance, be a jury question in the Seventh Circuit. Once entrapment becomes a jury question, it appears that the Seventh Circuit will allow a wide range of evidence to go to the jury on the theory that a wide variety of evidence is appropriate and probative.

In the past, courts have also found entrapment as a matter of law solely on the basis of impermissible governmental conduct. Although both the majority and the dissent in *Townsend* found there was not entrapment as a matter of law, they both discussed extensively cases specifically directed to that issue.[67]

In the early 1970's a line of cases found that entrapment existed as a matter of law when a government agent supplied contraband, the possession of which resulted in criminal charges being brought against the defendant.[68] Other cases found entrapment as a matter of law as a result of similar government over-

63 536 F.2d 170, 173-74 (7th Cir. 1976).

64 United States v. Ordner, 554 F.2d 24 cites *Spain* approvingly. *See also* United States v. Workopich, 479 F.2d 442 (5th Cir. 1973).

65 356 U.S. at 375-76.

66 This is not particularly difficult to predict in light of the *Townsend* court's actions in allowing admission of evidence of a conviction that had taken place over ten years prior to the offense being tried. *See* note 53 *supra.*

67 *See* note 26 *supra.*

68 *See* United States v. West, 511 F.2d 1083; United States v. Bueno, 447 F.2d 903.

involvement in criminal activity.[69] The rationale behind these cases has never been entirely clear. It appears, though, that the cases were based on a quasi-due process argument that prohibited conviction, even if the defendant was predisposed, because the government conduct was "shocking to [the court's] sense of justice."[70] Although this language is reminiscent of the words used by the Supreme Court to describe due process violations,[71] these recent cases used such language to support findings of entrapment as a matter of law.

Two examples of this method of analysis are *United States v. West*[72] and *United States v. Bueno,*[73] both discussed at length in *Townsend. Bueno* found that entrapment existed as a matter of law as a result of a government agent's activity in supplying the defendant with contraband, even though the defendant was predisposed.[74]

Russell v. United States[75] followed in 1973 and appeared to eliminate the rationale used in *Bueno.*[76] In *Russell,* on facts similar to those in *Bueno,* the United States Supreme Court found that such governmental conduct was not entrapment as a matter of law[77] or a violation of due process.[78] The court emphasized the element of predisposition and concluded that the defendant's concession of predisposition was fatal to his defense of entrapment.[79]

Russell did not completely foreclose the possibility of establishing entrapment as a matter of law based on government misconduct. The Court noted that, although the facts of *Russell* would not support the defense, a prosecution might be prohibited if the government's conduct was so outrageous that due process principles would constitute a bar.[80] In *West,* the Fifth Circuit apparently used this due process rationale to find entrapment as a matter of law when the defendant's uncontradicted testimony indicated that he had received narcotics from one informer for the purpose of sale to a government agent. This, the court found, was a case of "intolerable conduct by government agents,"[81] warranting reversal of the conviction.

The plurality in *Hampton v. United States* advocated rejection of any entrapment defense based on governmental misconduct when the predisposition of the defendant was established.[82] The plurality also indicated that a defendant's due process claim based on governmental overinvolvement with criminal activity is not a viable defense.[83] The concurring opinion took the position that there could be rare situations in which a predisposed defendant might successfully use a defense based on governmental overinvolvement.[84] When the plurality and the

69 *See* United States v. McGrath, 468 F.2d 1027; Greene v. United States, 454 F.2d 783.
70 468 F.2d at 1030.
71 *See* Rochin v. California, 342 U.S. 165 (1952).
72 *See* note 24 *supra.*
73 *See* note 24 *supra.*
74 447 F.2d at 906.
75 *See* note 15 *supra.*
76 411 U.S. at 432-33.
77 *Id.*
78 *Id.* at 431.
79 *Id.* at 436.
80 *Id.* at 431-32.
81 511 F.2d at 1086.
82 *See* note 25 *supra.*
83 425 U.S. at 490-91.

concurring opinions in *Hampton* are considered together, it appears that predisposition will be the decisive issue in virtually all entrapment cases, and that only the most egregious governmental conduct will support an entrapment defense when the defendant's predisposition is established.

The dissent in *Townsend* argued that the informant's testimony was necessary to rebut the defendant's testimony of governmental persuasion and inducement. It is not clear, however, whether the dissenting opinion was based on the belief that the lack of the informant's testimony created a reasonable doubt as to the defendant's predisposition,[85] or on the belief that the informant's testimony was required as a matter of due process.[86] Judge Swygert did not say that the informant's testimony was necessary as a matter of law or that the testimony's absence left entrapment established as a matter of law. It is obvious that Judge Swygert was uncomfortable with the government's conduct, but his dissenting opinion provides cryptic guidance as to what constitutes entrapment as a matter of law.

The majority concluded that due process did not require the informant's testimony,[87] and that sufficient evidence of predisposition existed without the informant's testimony.[88] The majority never found it necessary to address directly the issue of entrapment as a matter of law. It did, however, indicate in a footnote that it had not completely embraced the plurality's position in *Hampton*.[89] The Seventh Circuit might still find entrapment as a matter of law solely as a result of governmental conduct. Prior cases[90] and *Townsend,* however, indicate that governmental conduct would have to be extreme to support an entrapment defense.

Conclusion

Townsend demonstrates that the Seventh Circuit is a rather unfavorable forum in which to raise the entrapment defense. Defendants and defense counsel should be well aware of the serious consequences of raising the plea. The court will require the defendant to admit the offense prior to hearing the entrapment defense. This, of course, forecloses an appeal based on the sufficiency of the evidence of the substantive crime.

Once the defense is raised, the court will rarely, if ever, find entrapment as a matter of law. Because the court is willing to view such a wide range of evidence as evidence of predisposition, including demeanor evidence at trial, it is predictable that there will always be sufficient evidence of predisposition to reject a finding of entrapment as a matter of law.

Once entrapment becomes a jury issue, it appears that a wide range of evidence will be admissible to establish the existence of predisposition, including

84 425 U.S. at 492-93 (Powell, J., concurring).
85 555 F.2d at 162.
86 *Id.* at 166.
87 *Id.* at 157.
88 *Id.*
89 *Id.* at 155 n.3.
90 *See, e.g.,* United States v. Duff, 551 F.2d 187 (7th Cir. 1977); United States v. Spain, 536 F.2d 170; United States v. Quintana, 508 F.2d 867 (7th Cir. 1975).

rather stale convictions. If the jury does find that the defendant was predisposed, it will be extremely unlikely that the verdict will be overturned. If the court is willing to view a wide range of evidence as indicia of predisposition, then the court will be likely to find sufficient evidence to support a jury verdict.

The costs of a plea of entrapment in the Seventh Circuit are quite high. Prudent defense counsel, faced with an issue involving governmental involvement in criminal activity, should examine thoroughly all possible alternatives to the entrapment plea before subjecting the defendant to such obvious hazards.

David A. York

IV. Administrative Law

ADMINISTRATIVE LAW—FEDERAL WATER POLLUTION CONTROL ACT AMENDMENTS OF 1972—JUDICIAL REVIEW OF STATE PROMULGATED POLLUTION REGULATIONS IS NOT AVAILABLE IN FEDERAL COURT; CONFLICTS BETWEEN STATE AND FEDERAL POLLUTION REGULATIONS CANNOT BE JUDICIALLY RESOLVED.

*U.S. Steel v. Train**

The Federal Water Pollution Control Act (FWPCA) Amendments of 1972[1] altered the federal government's position concerning the regulation of water pollution. The Amendments instituted two major changes. First, the amount of water pollution would henceforth be measured by setting effluent limitations instead of water quality standards.[2] Second, emphasis was placed on pollution controls, and enforcement of such controls shifted from primarily a state matter to one of joint state and federal concern.[3]

States were given the opportunity to adopt effluent regulations, which must then be approved by the United States Environmental Protection Agency (EPA). However, should the state fail to adopt acceptable regulations, the power to promulgate the necessary regulations is reserved to the EPA.[4] The regulations, either approved or adopted by the EPA, become the basis for a National Pollution Discharge Elimination System (NPDES) permit,[5] a prerequisite to the discharge of any pollutant into the nation's waters.[6]

In *United States Steel Corp. v. Train,* the United States Court of Appeals for the Seventh Circuit examined the entire process of obtaining a pollution permit under the FWPCA. The appellant challenged the validity of the adoption, approval, and application of the effluent regulations contained in the NPDES permit issued by the EPA.

The challenges were raised by United States Steel, operator of the Gary

* 556 F.2d 822 (7th Cir. 1977). This case was a consolidation of two separate actions, one originated in the District Court for the Northern District of Illinois, the other a petition requesting review of the permit by the Seventh Circuit. Russell E. Train is the Administrator of the United States Environmental Protection Agency. The term Administrator and EPA will be used interchangeably throughout this article.

1 86 Stat. 816, Pub. L. No. 92-500, 33 U.S.C. § 1251 et seq. (Supp. III, 1973).

2 [1972] U.S. CODE CONG. & AD. NEWS 3675, which states:

> Under this Act the basis of pollution prevention and elimination will be the application of effluent limitations. Water quality will be a measure of program effectiveness and performance, not a means of elimination and enforcement. The Committee recommends the change to effluent limits as the best available mechanism to control water pollution. With effluent limits, the Administrator can require the best control technology; he need not search for a precise link between pollution and water quality.

3 [1972] U.S. CODE CONG. & AD. NEWS 3675, which states:

> The legislation will restore Federal-State balance to the permit system. Talents and capacities of those States whose own programs are superior are to be called upon to administer the permit system within their boundaries. The Administrator is to suspend his activity, insofar as the permit system is concerned, in these States.

The Supreme Court also noted these changes in EPA v. California ex rel. State Water Resources Control Board, 426 U.S. 200, 204-05, (1976).

4 33 U.S.C. § 1331, 33 U.S.C. § 1342 (Supp. III, 1973).

5 33 U.S.C. § 1342 (Supp. III, 1973).

6 33 U.S.C. § 1311 (Supp. III, 1973).

Works in Gary, Indiana. The mill, during the process of making steel products, draws water from Lake Michigan and each day discharges up to 775 million gallons of polluted water into the lake as well as into the Grand Calumet River.[7] United States Steel (hereinafter U.S. Steel) applied for a permit in 1971 under the Refuse Act Permit Program.[8] In 1972, the FWPCA took over the responsibility of issuing these permits, subject to § 402 of the FWPCA.[9] Subsequently, this application was treated as a NPDES permit, and a permit was issued stating specific effluent limitations and conditions. U.S. Steel chose not to accept the permit, and filed a request for adjudicatory hearing pursuant to 40 C.F.R. § 125.36, challenging the limitations and conditions of the permit. At the prehearing conference, the administrative law judge refused to consider issues dealing with water quality standards and NPDES regulations due to an asserted lack of jurisdiction to hear the issues. U.S. Steel then filed an action in the United States District Court for the Northern District of Illinois seeking declaratory and injunctive relief with respect to the issues struck from consideration at the prehearing conference.[10] The district court dismissed the complaint as failing to state a claim on which relief could be granted. The court based its decision upon the inappropriateness of judicial interruption of an ongoing administrative process in the absence of irreparable injury or plain deprivation of a constitutional right, and upon the general policy of avoiding piecemeal judicial review.[11]

While the suit was pending before the district court, an adjudicatory hearing was conducted and a limited remand order was issued by the EPA. Thereafter, the Regional Administrator substantially approved the original permit. U.S. Steel again appealed to the Administrator who denied review, and the permit was finally reissued on June 25, 1976. U.S. Steel then filed an action for review with the Seventh Circuit Court of Appeals.[12]

The Seventh Circuit was faced with three distinct issues in this case. The first involved the validity of the state water quality regulations as promulgated by the State of Indiana. The second issue concerned whether the adopted regulations were consistent with the FWPCA, thereby justifying the approval of the regulations by the EPA. The third issue was whether the application of the regulation by the EPA was contrary to the legislative intent of the FWPCA.

I. Adoption of the State Regulations

A. *Appeal from the District Court*

U.S. Steel commenced this action after the administrative law judge refused

7 556 F.2d 822, 830 (7th Cir. 1977).
8 33 U.S.C. § 407 (1970).
9 33 U.S.C. § 1342 (Supp. III, 1973).
10 District Court jurisdiction was based upon 28 U.S.C. § 1331, because the complaint stated a claim under the Constitution, the fifth amendment due process clause, and a Statute of the United States, the Administrative Procedure Act 5 U.S.C. § 551 et seq.
11 556 F.2d 822, 832 (7th Cir. 1977).
12 Jurisdiction in this action was based on 33 U.S.C. § 1369 (b)(1)(F), which states:

> Review of the Administrator's action . . . (F) in issuing or denying any permit under section 1342 of this title, may be had by any interested person in the Circuit Court of Appeals of the United States for the Federal judicial district in which such person resides or transacts such business upon application by such person.

It is important to keep in mind that two separate actions were before the court. The differing aspects and rationale of each will be explored by this comment.

to consider issues dealing with the validity of the state water pollution regulations. The company asserted that the court should either require the EPA to determine the validity of the regulations, or to undertake a judicial determination of their validity.

The effluent limitations in question had been promulgated by the Indiana Stream Pollution Control Board,[13] and were subsequently submitted to the EPA for approval, as required by the FWPCA.[14] Under the Act, the Administrator's subsequent approval effectively transformed these Indiana regulations into *federal* water quality standards for both Lake Michigan and the Grand Calumet River.[15] U.S. Steel had challenged the validity of these regulations in the district court, claiming that enforcement of these regulations prior to an administrative hearing dealing with their validity was a violation of due process. The steel producer's complaint sought a determination of the validity by either the EPA or by the district court itself.

The Seventh Circuit held that the EPA was not required to determine the validity of the regulations. Moreover, the court asserted that the district court could not reach any determination as to the validity of the regulations either. The court explained:

> Because the Administrator is required by the Act to include in the permit any more stringent state limitations, including those necessary to meet state water quality standards, and is given no authority to set aside or modify those limitations in a permit proceeding, he correctly ruled that he had no authority to consider challenges to the validity of the state water quality standards in such a proceeding. . . . Nor could the District Court have properly granted U.S. Steel's alternative request that the court itself review the validity of those standards under the United States Constitution. As we have seen, the standards are state, not federal, regulations and the Administrator was required by the Act to include in the permit any discharge limitations necessary to meet them.[16]

The Seventh Circuit thus held that the regulations in question were state regulations and therefore it did not have jurisdiction in the case. However, it should be noted that through the subsequent step of approval by the EPA, the validity of the state regulations arguably was transformed into a federal question.

For example, *United States v. Bellingham Bay Boom Co.*[17] involved a case where the laws of Washington permitted the building of booms, devices which facilitate the transportation of logs but at the same time restrict the flow of river traffic. The Federal Rivers and Harbors Act of 1890[18] prohibited obstruction to the navigable capacity of any waters. The Act, however, specifically excepted from its prohibitions those obstructions authorized by state law. The Supreme Court held the determination of whether the state law was valid with respect to

13 Indiana Stream Pollution Control Board Regulation SPC4R (1972), Indiana Stream Pollution Control Board Regulation SPC7R-2 (1973).
14 33 U.S.C. § 1311 (Supp. III, 1973).
15 *Id.*
16 556 F.2d 822, 835, 837 (7th Cir. 1977).
17 176 U.S. 211 (1900).
18 26 Stat. 426 (1890).

the Rivers and Harbors Act to be a federal question. The Court stated that if there were no federal law in existence, the question of whether the boom was authorized by a state law would be exclusively a state question. Since the federal law had been passed, however, the question shifted to one of whether the structure was permitted by that federal law. Therefore, if federal law says that a practice may continue if affirmatively authorized by the state law, the question of whether it is so authorized in effect becomes an issue for the federal courts to decide.[19]

The situation confronting U.S. Steel was indistinguishable from that confronting the petitioner in *Bellingham Bay Boom*. The federal act in the instant case authorized the existence of the state regulations only if affirmatively approved by the FWPCA. Therefore, notwithstanding the Seventh Circuit's holding to the contrary, the validity of the state regulations was properly a question for the federal courts to decide.

B. *Petition to the Seventh Circuit*

U.S. Steel also challenged the validity of the regulations in its petition to the Seventh Circuit.[20] The company's direct petition to the court of appeals was essentially an attempt by the company to obtain judicial review of the regulations in an indirect manner by arguing that the Administrator cannot apply the regulations to U.S. Steel without first judging their validity.

U.S. Steel asserted that this aspect of the case was controlled by *Consolidated Coal Company v. EPA*.[21] In that case, Consolidated Coal (Consol) was discharging pollutants in the course of operating a coal mine. As a result of concern by state representatives about the discharge of iron found in the water in southern West Virginia, the state decided to issue a permit with a duration of two years. Since it was unlawful to pollute without a permit,[22] Consol would have been required to apply for another permit and adapt its facility to any more stringent standards at that time. Consol argued that the time limitation suggested by the state officials was not required in issuing a NPDES permit. Consol cited 40 C.F.R. § 125.22 and 40 C.F.R. § 125.15, stating that these sections give the Administrator discretion concerning the inclusion of a time limitation. Also, since review of the regulations was not available on the state level, Consol argued that the court should require an administrative hearing concerning the regulations before the permit could be issued.

The Fourth Circuit agreed with Consol, asserting that the time limitation imposed upon the permit raised issues that entitled Consol to a hearing at either the state or federal level prior to any final administrative action. Since there was no opportunity for a state hearing, the court held that due process required that the administrator grant a hearing in the case.[23]

U.S. Steel argued that the facts in its case were indistinguishable from those in *Consolidated Coal* and therefore the Seventh Circuit should similarly mandate

19 176 U.S. 211, 218 (1900).
20 Jurisdiction was based upon 33 U.S.C. § 1369, which permits direct petitions to the Circuit Court of Appeals.
21 537 F.2d 1236 (4th Cir. 1976).
22 33 U.S.C. § 1311 (Supp. III, 1973).
23 537 F.2d 1236, 1239 (4th Cir. 1976).

an administrative hearing. U.S. Steel based this argument on two key points of similarity between *Consolidated Coal* and *U.S. Steel.* First, there was no pre-enforcement judicial review of the state regulations available to U.S. Steel. Second, it argued that the time limitation imposed upon Consol was equivalent to the effluent limitations imposed in the instant case.

The first issue concerns the availability of pre-enforcement judicial review concerning the Indiana Stream Pollution Control Board regulations. The adoption of these regulations is governed by two sections of the applicable Indiana statutes. The first section deals with provisions governing procedures that must be followed in administrative rulemaking.[24] The statute does not, however, provide for judicial review. The second section pertinent to the question of pre-enforcement judicial review is the Administrative Adjudication Act.[25] The Act defines administrative adjudication as "the administrative investigation, hearing and determination of any agency issues or cases applicable to particular persons, excluding, however, the adoption of rules and regulations."[26]

Also, no declaratory relief from an Indiana court was available concerning the state regulation.[27] The lack of available declaratory relief, coupled with the two previously cited sections of the Indiana statutes, foreclosed any possibility of state judicial review concerning the regulations to U.S. Steel.

However, to establish *Consolidated Coal* as controlling, it was also necessary for U.S. Steel to show that the time limitation imposed upon the Consol permit and the effluent limitations contained in its permit were equivalent. An examination of each limitation, however, demonstrates that the limitations are not equivalent and therefore the cases are clearly distinguishable. The cases differ dramatically with respect to the discretion accorded the Administrator concerning time and effluent limitations, respectively. Whereas the Administrator in *Consolidated Coal* had discretion concerning the time limitation of the permit, the Administrator in *U.S. Steel* had no such discretion concerning the effluent limitations.

The time limitation imposed upon the permit in the *Consolidated Coal* case was not specifically provided for by the FWPCA. The Act states that any certification shall set forth any effluent limitations and other limitations necessary to assure compliance of the requirements set by the FWPCA.[28] The only definite statement as to the duration of the permit is contained in 40 C.F.R. § 125.25,[29] which states:

> (a) No permit will issue for a period longer than 5 years.
> (b) Permits of less than 5 years' duration may issue in appropriate cases and

24 IND. CODE ANN. § 4-22-2-1-11. (Burns 1976).
25 IND. CODE ANN. § 4-22-1-1-30. (Burns 1976).
26 IND. CODE ANN. § 4-22-1-2 (Burns 1976).
27 Dionisopoulos, *Procedural Safeguards in Administrative Rule Making in Indiana,* 37 IND. L.J. 423, 434 (1962).
28 33 U.S.C. § 1341 states:

> Any certification provided under this section shall set forth any effluent limitations and other limitations, and monitoring requirements necessary to assure that any applicant for a Federal license or permit will comply with any applicable effluent limitations and other limitations, under section 1311 or 1312 of this title. . . .

29 40 C.F.R. § 125.1 et seq. was the result of 33 U.S.C. § 1342. It set forth certain procedures that the EPA must follow in issuing a NPDES permit.

> Regional Administrators shall give great weight to the advice of State or interstate water pollution control officials on the appropriate duration for particular permits.[30]

The words "may" and "great weight" indicate that the Administrator clearly has discretion regarding the time limitation imposed upon a permit. In *Consolidated Coal* the Administrator exercised this discretion without any input from Consol. The facts of this case show that Consol was never granted an opportunity to express its position regarding the permit's time limitation. Consol claimed this was a violation of the due process clause. The Fourth Circuit agreed, and held that there must be an adjudicatory hearing concerning the time limitation before the permit is issued.[31]

In contrast, *U.S. Steel* involved a clearly distinct issue: effluent limitations. U.S. Steel asserted that the Indiana Regulations were too stringent, and contrary to the FWPCA. U.S. Steel contended that the appropriate remedy would require the Administrator to determine the validity of these standards before applying them to U.S. Steel's permit.

The FWPCA deals with the ability of the Administrator to modify stringent state regulations in two sections. First, § 510 of the Act relates to state authority in promulgating pollution regulations. It states:

> [E]xcept as expressly provided in this chapter, nothing in this chapter shall (1) preclude or deny the right of any State or political subdivision thereof or interstate agency to adopt or enforce (A) any standard or limitation respecting discharges or pollutants. . . .[32]

Second, § 301 of the Act deals with the incorporation of state regulations into the federal act. It states that in order to carry out the objective of the Act the Administrator is required to adopt any more stringent limitations established pursuant to any state law or regulation.[33] This section goes beyond merely incorporating the state regulations into the federal act. Rather, it expressly states that in order to reach the goals set by the Act, a polluter must comply with pertinent state law.

The authority given the states in promulgating effluent limitations, coupled with the requirement of mandatory inclusion in any permit issued, afford the Administrator no discretion concerning the incorporation of state effluent limitations in a permit. Therein lies the crucial distinction between *Consolidated Coal* and *U.S. Steel.* The Administrator in *Consolidated Coal* was granted discretion by the FWPCA concerning the time limitation of the permit. However, in *U.S. Steel* the Administrator had no discretion regarding state promulgated effluent

30 40 C.F.R. § 125.25 (1976).
31 537 F.2d 1236, 1239 (4th Cir. 1976).
32 33 U.S.C. § 1370 (Supp. III, 1973).
33 33 U.S.C. § 1311 states:

> In order to carry out the objective of this chapter there shall be achieved— . . . not later than July 1, 1977, any more stringent limitation, including those necessary to meet water quality standards, treatment standards, or schedules of compliance, established pursuant to any State law or regulations (under authority preserved by section 1370 of this title) or any other Federal law or regulation, or required to implement any applicable water quality standard established pursuant to this chapter.

limitations. If the Seventh Circuit had agreed with the Fourth Circuit and forced the Administrator to conduct an adjudicatory hearing concerning the effluent limitations, its decision would have been in direct conflict with the language and intent of the FWPCA. The result in *U.S. Steel* indicates that the Seventh Circuit correctly recognized this vital distinction between *Consolidated Coal* and the case before it,[34] and thereby rendered a decision consonant with the intent of the Act.

II. Approval by the Administrator

The second step in the issuance of a permit under the FWPCA requires that the Administrator approve the regulations that have been adopted by a state.[35] An appeal of the Administrator's approval is clearly a federal question. Section 509 of the Act involves issues that are appealable directly to a court of appeals. However, appeal of the Administrator's approval is not provided for in § 509 of the FWPCA.[36] This statutory silence raises the question whether any judicial review of the Administrator's approval is available.

Bethlehem Steel v. Environmental Protection Agency[37] indicates that judicial review of the Administrator's decision is available even if it is not expressly provided for in the FWPCA. In *Bethlehem Steel,* the steel company petitioned the Second Circuit for statutory review[38] of the Administrator's approval of state water quality standards pursuant to § 303 of the FWPCA.[39] The Second Circuit held that it was without jurisdiction in the matter because the petition requested review of issues not contained in § 509 of the FWPCA, the jurisdictional provision of the Act. However, in upholding the position espoused by the EPA, the court stated:

> We would be more skeptical of EPA's argument that we lack jurisdiction over Bethlehem's petition if EPA also argued that *no court* had jurisdiction to review such actions. The legislative history shows no intention to put any agency action under the FWPCA beyond judicial review. (Emphasis added.)[40]

The implicit suggestion by the Second Circuit in *Bethlehem Steel* that an alternative route for judicial review might be available was made express by the

34 The Seventh Circuit stated:
> Under § 402 of the FWPCA, the Administrator must condition the NPDES permit upon the discharger's meeting "all applicable requirements under section 301," *et al.* . . . Because the Administrator is required by the Act to include in the permit any more stringent state limitations, including those necessary to meet state water quality standards, and is given no authority to set aside or modify those limitations in a permit proceeding, he correctly ruled that he had no authority to consider challenges to the validity of the state water quality standards in such a proceeding.

556 F.2d 822, 835 (7th Cir. 1977).

35 33 U.S.C. § 1313. The Administrator can either approve the state regulations, or suggest changes to which the state regulations must conform. However, if the state does not adopt regulations then the Administrator must propose his own.

36 33 U.S.C. § 1369 (Supp. III, 1973).

37 538 F.2d 513 (3rd Cir. 1976).

38 33 U.S.C. § 1369 (Supp. III, 1973).

39 538 F.2d 513, 514 (2d Cir. 1976).

40 538 F.2d 513, 517 (2d Cir. 1976).

Seventh Circuit in *U.S. Steel.* The Seventh Circuit, noting that it did not have original jurisdiction in the matter, emphasized that: "the District Court in this case, however, did have authority to review the Administrator's approval, prior to the permit proceeding, of the Indiana water quality standards as consistent with the FWPCA."[41]

The Seventh Circuit's holding recognizes the vital distinction between adoption and approval of the regulations. This distinction is not only important conceptually, but it also provides a potential avenue of judicial review. That is, while *adoption* of the regulations by Indiana is not reviewable, the EPA's *approval* of these regulations is subject to judicial review.

The issues involved in the approval of regulations are distinguishable from issues concerning their adoption. The issue of adoption of the regulations relates to the water pollution limitations themselves, *e.g.,* whether the polluter can meet the prescribed limitations by employing best practicable technology.[42] As previously stated, the Seventh Circuit held that the Administrator had no discretion concerning the adoption of state regulations, and the question of whether the Indiana regulations were best practicable technology was not resolved. The issue of approval by the Administrator of the state-adopted regulations, on the other hand, focuses on the Administrator's decision as to whether the regulations "are consistent with the applicable requirements of the act. . . ."[43]

The Seventh Circuit did not have to decide whether the regulations are consistent with the Act because the court held that U.S. Steel's complaint concerning the approval of the regulations by the EPA was insufficient as a matter of law.[44] U.S. Steel pleaded only the bare assertion that the Indiana regulations were contrary to the FWPCA, without alleging the facts necessary to substantiate this conclusion.[45] As a result, the court did not reach the merits of this issue. Nevertheless, the Seventh Circuit's ruling is important. The court's recognition of the availability of judicial review will serve as a guideline to subsequent litigators challenging the EPA's approval of state regulations.

III. Application of the Regulations

U.S. Steel also challenged the application of the regulations by asserting that compliance with the state limitation regarding sulphate pollution would result in its inability to comply with the federal restriction governing discharge of total suspended solids (TSS).[46] The sulphate limitations are state limitations adopted by Indiana under § 303 of the FWPCA. The limitations on TSS is a federal regulation adopted pursuant to § 402 of the FWPCA, which states that permits are issued under § 402 upon "such conditions as the Administrator determines are necessary to carry out the provisions of the Act."[47]

U.S. Steel asserted that to achieve the federally required level of TSS pollu-

41 556 F.2d 822, 837 (7th Cir. 1977).
42 The FWPCA based pollution limits for 1977 on best practicable technology "BPT."
43 33 U.S.C. § 1313 (Supp. III, 1973).
44 556 F.2d 822, 837 (7th Cir. 1977).
45 *Id.*
46 556 F.2d 822, 846 (7th Cir. 1977).
47 33 U.S.C. § 1342 (Supp. III, 1973).

tion would necessitate the use of blast furnace recycling, which is best practicable technology (BPT). However, use of blast furnace recycling would necessarily result in violations of the *state* regulations regarding sulphate discharge. Therefore, U.S. Steel claimed a variance should be allowed from the limitation of TSS based upon BPT, since it could not employ BPT without running afoul of the state limitation.

The Seventh Circuit, however, rejected this argument, stating:

> [T]he existence of state wasteload allocations requiring limitations more stringent than the federal, technology-based limitations should not create a loophole through which compliance with the federal limitations may be evaded. Section 301 (b) (1) (C) can hardly have been intended to authorize a state, by imposing limitations incompatible with BPT, to allow its industries to escape their duty to comply with nationally uniform federal limitations . . . Thus, we hold that the existence of more stringent state limitations is not one of the "factors" to be considered in determining whether an individual point source is entitled to a variance from a limitation based on BPT . . .[48]

This holding accurately reflects the legislative intent of both §§ 303 and 402 of the FWPCA. The FWPCA Amendments of 1972 were intended to implement a combined effort of the federal and state governments to establish uniform effluent limitations by July 1, 1977,[49] and eventually to eliminate the discharge of all pollutants into navigable waters by 1985.[50] If U.S. Steel were allowed to pit the federal standards against the state standards in seeking a variance from federal regulations, the clear legislative purposes of the FWPCA would be frustrated. In fact, the efforts of the two governmental bodies would be placed in direct conflict. Since Congress intended that both state and federal governments work toward the elimination of water pollution, the Seventh Circuit's holding that a state-adopted limitation cannot be a basis for granting a variance from a federal limitation clearly effectuates the legislative purpose of the Act.

The other holdings concerning the application of the regulation to U.S. Steel, however, are of limited importance for three reasons. First, pursuant to § 301 of the FWPCA, the Administrator must include more stringent state regulations in the NPDES permit.[51] Therefore, any challenge by U.S. Steel involving the stringency of the regulations would go against the clear language of the FWPCA. Secondly, the Seventh Circuit repeatedly states that claims brought by U.S. Steel were either too vague or are not founded on the facts necessary to prove their case.[52] Therefore, the court did not have to decide these issues on the facts and no precedent was established. Thirdly, other applications of these regulations are limited to the facts of this case and will not be of great value unless another steel mill is similarly situated to the one in this case.

48 556 F.2d 822, 847 (7th Cir. 1977).
49 [1972] U.S. CODE CONG. & AD. NEWS 3675.
50 33 U.S.C. § 1313 (Supp. III, 1973).
51 33 U.S.C. § 1311 (Supp. III, 1973).
52 There were four areas; chemical limitations, technology-based effluent limitations, statistical analysis, surface run-off where the court held that the facts alleged were insufficient as a matter of law. Therefore, the court did not reach a decision on the merits concerning these four items. 556 F.2d 839-43 (7th Cir. 1977).

IV. Conclusion

The main issues resolved in this case concerned the availability of judicial review for the adoption and approval of state pollution regulations. The case is important not so much for its denial of review in the instant case, but for its suggestion that alternative avenues of judicial review are available. Moreover, *U.S. Steel* establishes guidelines concerning the availability of judicial review at each step of the process that results in a NPDES permit.

U.S. Steel establishes that a court of appeals cannot confer discretion upon the Administrator of the EPA when the FWPCA did not expressly delegate discretion to him. The Seventh Circuit's holding denying review of the state regulation by the Administrator reflects the overriding legislative intent of the FWPCA. Congress was explicit in declaring that states have the opportunity to adopt regulations, and further that the Administrator's only role is to assure that state regulations conform to the requirements of the Act.

The Seventh Circuit stated that in applying the regulations compliance with both state and federal limitations must be achieved, even though there is a conflict between the two regulations. The court was restrained in dealing with this conflict because of the express statutory language of the FWPCA, which states that the Administrator must include state limitations when issuing a permit. Also, the federal limitations must be uniform throughout the nation, and therefore no variance is possible with respect to a single plant. As a result, the Act gave the court no choice but to order compliance with both standards. The decision makes clear that any resolution of this problem must originate in the legislature and not in the courts.

The most important aspect of *U.S. Steel* is that judicial review is only available if certain conditions are met. If the subject matter for appeal is specifically set out in § 509 of the FWPCA the action must originate in a court of appeals. However, as *Bethlehem Steel* and *U.S. Steel* make clear, matters not contained in § 509 are not immune from judicial review. These issues may be properly adjudicated in a district court.

Moreover, although relief was denied petitioner in the instant case, judicial review of state-adopted regulations may be available if the petitioner shows that by the Administrator's approval the validity of the regulations has become a federal question, and is therefore within the ambit of *United States v. Bellingham Bay Boom Co.*[53]

However, to obtain review in any forum, the complaint must be specific in stating the issues involved and the remedy sought. The petitioner must carefully relate his facts to each particular step in the permit process. For example, if the challenge concerns the approval of the standards by the EPA, the petitioner must assert the Administrator's action was arbitrary, capricious, an abuse of discretion, or otherwise failed to meet statutory requirements. If, on the other hand, the challenge involves the application of the regulations, the petitioner must prove that the regulations are contrary to the FWPCA.

53 176 U.S. 211 (1900).

In *U.S. Steel,* the petitioner had not met these conditions and review was accordingly denied. Thus, the decision indicates that while federal review of pollution regulation is available, the Seventh Circuit will require strict adherence to its prescribed conditions of review. The limited availability of judicial review established in *U.S. Steel* produces an ambivalent result. While petitioners are discouraged from bringing groundless challenges to regulatory measures, many legitimate complaints may also be precluded from judicial review. For example, in the instant case, the court was precluded from resolving a conflict between state and federal pollution regulations. This result must be judged in light of the legislative intent of the Act. The primary focus of the Act was to combine state and federal governments in an effort to control water pollution. The decision, when judged in this context, is seen to implement effectively the congressional design to promote state and federal cooperation toward the end of a cleaner environment.

Thomas P. Fitzgerald

SECURITIES REGULATIONS—AN AGREEMENT TO ARBITRATE FUTURE CONTROVERSIES IN NON-INTERNATIONAL CONTRACTS IS VOID AND UNENFORCEABLE UNDER THE SECURITIES EXCHANGE ACT.

*Weissbuch v. Merrill Lynch, Pierce, Fenner and Smith, Incorporated**

I. Introduction

A dilemma posed by the conflict of federal arbitration policies with federal securities laws confronted the United States Court of Appeals for the Seventh Circuit in *Weissbuch v. Merrill Lynch, Pierce, Fenner and Smith, Incorporated.* The specific issue addressed in *Weissbuch* was whether the arbitration clause of an investment agreement violated the Securities Exchange Act of 1934. Thus, the court faced the predicament of reconciling two important national policies.

The Seventh Circuit resolved the issue by adhering to a long-standing judicial preference for the Securities Acts. It held the agreement to arbitrate future controversies invalid under the nonwaiver of protected rights provision of the Securities Exchange Act. In so doing, the Seventh Circuit failed to examine the facts and apply an analysis which would avoid the subordination of one national policy to another. Had it used such a methodology, the court would have found the contract law doctrine of adhesion contracts a well-adapted analytical tool.

II. The Controversy

The dispute in *Weissbuch* involved an individual investor and a large brokerage firm. The plaintiffs, Henry and Elaine Weissbuch, signed a standard form contract with Merrill Lynch to open a trading account. A provision of this agreement specified that any controversy arising under the contract would be settled by arbitration. Under the defendant's management, the Weissbuchs suffered considerable losses on their investments. These losses provoked the suit against Merrill Lynch. Seeking both legal and equitable relief, the plaintiffs alleged a violation of Securities Exchange Commission rule 10b-5,[1] fraud and deceit, and breach

* 558 F.2d 831 (7th Cir. 1977).

1 17 C.F.R. 240.10b-5 (1977). Rule 10b-5 was issued under the authority granted by § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1970). Section 10(b) provides:

> It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange:
>
> . . . .
>
> (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.

Rule 10b-5 states:

> 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,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

of contract. The defendant moved to stay the proceedings in the district court, citing the arbitration clause in the written agreement. The court granted the stay with regard to the fraud and breach of contract allegations. It held, however, that the claim under rule 10b-5 was not subject to arbitration.

On appeal to the Seventh Circuit, the defendant challenged the sufficiency of the Weissbuchs' rule 10b-5 claim for failure to allege *scienter.*[2] In addition, Merrill Lynch objected to the district court's finding that the arbitration agreement was invalid and unenforceable with respect to a 10b-5 claim. The plaintiffs moved to dismiss the appeal on the ground that the district court's holding was not an appealable interlocutory order.

A. *The Imposition of the* Wilko *Rule*

The Seventh Circuit rejected each of the allegations raised on the appeal by both the defendant and the plaintiffs. First, it denied the Weissbuchs' motion to dismiss the appeal, holding that the district court's ruling qualified as an appealable interlocutory injunction order under 28 U.S.C. § 1292(a)(1).[3] The court also found that the plaintiff's complaint adequately alleged *scienter* on the part of the defendant. Finally, it held that the arbitration clause could not be invoked against the plaintiff's rule 10b-5 claim.

The Seventh Circuit applied the Supreme Court's decision in *Wilko v. Swann*[4] to the rule 10b-5 claim. *Wilko* involved an individual investor who entered into a margin agreement with the defendant brokerage firm. As in *Weissbuch,* a standard form contract was used to define the relationship between the plaintiff and the broker. The agreement included an arbitration clause covering any disputes between the parties. The investor and the defendant subsequently entered into a second contract for the sale of stock.[5] Some time after this sale, the plaintiff filed suit under § 12(2) of the Securities Act of 1933.[6] He

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(c) To engage in any act, practice or course of business which operates or would operate as fraud or deceit upon any person, in connection with the purchase or sale of any security.

2 Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). In *Hochfelder,* the Court held that § 10(b) claims require some element of *scienter,* as opposed to mere negligent conduct.

3 28 U.S.C. § 1292(a)(1) (1970) provides in part:

The courts of appeal shall have jurisdiction of appeals from:

(1) Interlocutory orders of district courts . . . granting, continuing, modifying, refusing or dissolving injunctions. . . .

In Alberto-Culver Co. v. Scherk, 484 F.2d 611, 614 (1973), the Seventh Circuit held that a district court's refusal to stay proceedings pending arbitration was an "injunction." Consequently, the district court's order was held an appealable interlocutory order under 28 U.S.C. § 1292(a)(1). *See also* Ettelson v. Metropolitan Life Insurance Co., 317 U.S. 189, 191-92 (1942) (District court order that an equitable counterclaim be tried separately from the complaint held an appealable interlocutory injunction.); Shaneferoke Coal and Supply Corp. v. Westchester Service Corp., 293 U.S. 449, 451-52 (1935). (District court order staying legal proceedings until the chancellor had considered an equitable defense held appealable.)

4 346 U.S. 427 (1953).

5 Wilko v. Swann, 107 F.Supp. 75, 76-77 (S.D. N.Y. 1952).

6 15 U.S.C. § 77 l (1970). The section provides:

Any person who:

. . . .

(2) offers or sells a security (whether or not exempted by the provisions of § 77c of this title, other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were

alleged that the defendant had knowingly misrepresented the stock and that he had suffered a loss on it.[7] The defendant, relying on the margin agreement, moved to stay the proceedings in the district court until the dispute had been arbitrated.[8]

On the basis of these facts and pleadings, the district court denied the motion[9] on the ground that arbitration violated the 1933 Act. The Second Circuit reversed the lower court,[10] reasoning that arbitrators would be bound by the same 1933 Act standards as a judge. The Supreme Court overturned the decision of the Court of Appeals.[11] The Court maintained that § 12(2) of the Securities Act created a special private right of action for misrepresentation.[12] It held the agreement to arbitrate future controversies void under § 14 of the 1933 Act[13] as a "stipulation" binding the investor to "waive compliance" with a "provision" of the Act.[14] The Supreme Court also considered the superior bargaining power of most professional sellers in the securities market. This bargaining advantage could only be mitigated, the Court concluded, if buyers retained their right under § 22(a) of the 1933 Act to select a judicial forum.[15] Finally, the Supreme Court refused to recognize judicial review of arbitration awards as consistent with the protection of legal rights guaranteed under the 1933 Act.[16]

Weissbuch differed from *Wilko* in that it was based on the Securities Act of 1934.[17] Section 10(b) of the 1934 Act[18] closely parallels § 12(2) of the Secu-

made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

7 346 U.S. at 428-29.

8 107 F. Supp. at 76.

9 *Id.* at 79.

10 Wilko v. Swann, 201 F.2d 439, 444-45 (2d Cir. 1953).

11 426 U.S. at 438.

12 *See* note 6 *supra.*

13 426 U.S. at 438. Section 14 of the 1933 Act, 15 U.S.C. § 77n (1970), provides: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

14 346 U.S. at 434-35.

15 *Id.* at 435; Securities Act of 1933, § 22(a); 15 U.S.C. § 77(v) (1970). The text provides:

> (a) The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commissioner in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in §§ 225 and 347 of Title 28. No case arising under this subchapter and brought in any state court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against it in the Supreme Court or such other courts.

16 346 U.S. at 438. *See also* Bernhardt v. Polygraphic Company of America, Inc., 350 U.S. 198, 203 (1956).

17 The 1933 Act is primarily concerned with the initial distribution of securities, whereas the 1934 Act deals with subsequent trading. *See* text accompanying notes 30-35 *infra.*

rities Act of 1933.[19] It varies from the 1933 Act provision in that § 10(b) does not expressly create a private right of action. The Supreme Court, however, has recognized the existence of an implied private right of action under § 10(b).[20] Consequently, the Seventh Circuit settled the issue by imposing the *Wilko* rule.

In applying the *Wilko* doctrine, the court relied more on a traditional analysis than on the facts of the case. It never looked into the nature of the original transaction between the Weissbuchs and Merrill Lynch. The Seventh Circuit did not consider the relative disparity of bargaining power between the parties. It did not examine the standard form contract used to determine the terms of the agreement. In brief, the court failed to recognize that the arbitration clause amounted to an onerous term imposed by an overreaching party. Thus, the Seventh Circuit mechanistically decided *Weissbuch* with at best a superficial analysis of the issues involved.

III. A Conflict of National Policies

The Seventh Circuit in *Weissbuch* recognized that the fundamental issue involved a conflict between two established national policies. The court noted "a strong national policy favoring the recognition of arbitration agreements as a means of resolving private conflicts short of the more costly and disruptive avenue of litigation."[21] The court also observed "a strong national policy underpinning the Securities Acts of 1933 and 1934."[22] It emphasized that the Acts were "passed with an eye to the disadvantages confronting the small investor."[23] Thus, *Weissbuch* involved a confrontation between the fundamental principles of freedom of contract and unobstructed transaction of business, on one hand, and public policy considerations on the other. Whereas the former principles support a waiver of statutory rights, the latter considerations demand the protection of the small investor.

A. *The United States Arbitration Act*

The "strong national policy favoring the recognition of arbitration agreements" lies in the United States Arbitration Act of 1925.[24] The Act abolishes the common law practice by which courts refused to enforce contractual arbitra-

18 *See* note 1 *supra.*

19 *See* note 6 *supra.*

20 *See, e.g.,* Ernst and Ernst v. Hochfelder, 425 U.S. 185 (1976); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 730 (1975); Affiliated Ute Citizens v. United States, 406 U.S. 128, 150-54 (1972); Superintendent of Insurance v. Bankers Life and Casualty Co., 404 U.S. 6, 13 n.9 (1971).

21 558 F.2d at 833.

22 *Id.* at 834.

23 *Id.* at 834. In this respect, too, the Seventh Circuit reflected the reasoning of the Supreme Court in *Wilko*:

> Two policies, not easily reconcilable, are involved in this case. Congress has afforded participants in transactions subject to its legislative power an opportunity generally to secure prompt, economical and adequate solution of controversies through arbitration if the parties are willing to accept less certainty of legally correct adjustment. On the other hand, it has enacted the Securities Act to protect the rights of investors and has forbidden a waiver of any of those rights.

346 U.S. at 438.

24 9 U.S.C. §§ 1-14 (1970).

tion agreements. It is designed to ensure that written arbitration agreements shall be "valid, irrevocable, and enforceable."[25] The Act provides for a stay of proceedings with regard to any issue referable to arbitration according to the parties' written agreement.[26] If a "failure, neglect, or refusal" of any party to honor an arbitration agreement exists, the Act directs a federal court to order the parties to arbitrate.[27] The Act has been specifically construed to apply to securities transactions.[28] Its legislative history reveals that Congress intended to provide parties with a means of avoiding "the costliness and delays of litigation" while preserving the effective enforcement of their rights.[29]

B. *The Securities Acts*

The other "strong national policy" involved in *Weissbuch* concerns the federal regulation of securities. This policy is set forth in the 1933[30] and 1934[31] Acts. The 1933 Act deals essentially with the initial distribution of securities, rather than subsequent trading. It imposes both civil and criminal liability for material misstatements, omissions, or misrepresentations of fact.[32] The Act aims primarily to protect investors by means of a twofold requirement.[33] First, all securities must be registered with the Securities Exchange Commission.[34] Second, certain information concerning the securities must be published before they are offered for sale. The 1934 Act supplements the 1933 Act by placing similar constraints on subsequent trading of securities after issue.[35]

IV. The Judicial Preference for the Securities Acts

By imposing the *Wilko* rule, the Seventh Circuit followed a long-standing judicial practice of subordinating the Arbitration Act to the Securities Acts. Section 29(a) of the 1934 Act and § 14 of the 1933 Act, the nonwaiver pro-

25 9 U.S.C. § 2 (1970).
26 9 U.S.C. § 3 (1970).
27 9 U.S.C. § 4 (1970).
28 *See, e.g.,* Scherk v. Alberto-Culver Co., 417 U.S. 506, 511 (1974); Wilko v. Swann, 346 U.S. 427, 438 (1953); Reader v. Hirsh & Co., 197 F. Supp. 111, 113 (S.D.N.Y. 1961).
29 H. R. REP. No. 96, 68th Cong., 1st Sess. 1, 2 (1924); *see also* S. REP. No. 536, 68th Cong. 1st Sess. (1924).
30 15 U.S.C. §§ 77a-77bbbb (1970).
31 15 U.S.C. §§ 78a-78lll (1970).
32 L. LOSS, SECURITIES REGULATION 83-84 (1951).
33 A. C. Frost & Co. v. Coer D'Alene Mines Corp., 312 U.S. 38, 40 (1941); Wilko v. Swann, 346 U.S. at 430-31; Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976). *See* H. R. REP. No. 85, 73d Cong. 1st Sess., 1-5 (1933); 1 L. LOSS, SECURITIES REGULATION 316-31 (1951).
34 The registration statement requires, *inter alia,* information concerning the issuer's organization, directors, principal officers, promoters, underwriters, major stockholders, character of business, capitalization, debt, proposed public offering price, conditions of the underwriter's contract, and opinions of counsel with regard to the legality of the issue.
35 L. LOSS, SECURITIES REGULATIONS 130-31 (1951). Loss identifies four basic purposes of the 1934 Act:

> [1] to afford a measure of disclosure to people who buy and sell securities; [2] to prevent and afford remedies for fraud in securities trading and manipulation of markets; [3] to regulate the securities markets; and [4] to control the amount of the Nation's credit which goes into those markets.

visions of the respective Acts, are generally construed to achieve this effect.[36] Arbitration agreements amount to "provisions" which waive the investor's right to selection of remedies under the Acts. Thus, any agreement to arbitrate future disputes arising under either Act is prohibited.

A. *The Shortcomings of Arbitration*

The judicial preference for the Securities Acts reflects the conclusion that an investor's rights are better protected by the legal process than by arbitration. If a contractual arbitration clause were invoked, the securities purchaser would lose considerable substantive and procedural protections.[37] Arbitrators generally lack judicial instruction on the law. Their decisions are frequently made without explanation or a discussion of their reasons. Arbitrators are not required to keep a complete record of their proceedings. As a result, their conception of the legal meaning of such statutory requirements as "burden of proof," "reasonable care," "material fact," or "*scienter*" cannot be examined. Consequently, the judicial review of an arbitration award is necessarily more limited than that of a judgment. The investor also forfeits his rights to the extensive discovery process provided by the Federal Rules of Civil Procedure. Finally, the securities purchaser is deprived of the wide selection of venue under the 1934 Act.[38]

An agreement to arbitrate future disputes not only affects an investor's substantive and procedural protections, but also his choice of remedies.[39] The en-

36 *See, e.g.,* Starkman v. Seroussi, 377 F. Supp. 518 (S.D.N.Y. 1974) (agreement to arbitrate future controversies voided on the ground that it denied the plaintiff his right to enforce a liability or duty created by the 1933 or the 1934 Acts.); Moran v. Paine, Webber, Jackson & Curtis, 389 F.2d 242 (3rd Cir. 1968) (the court commenting that "[t]he Act of 1934 . . . is supplementary to that of 1933, . . . accordingly, the same logic is applicable to the Act of 1934, as is applicable to that of 1933, and, therefore, to both nonwaiver sections."); Reader v. Hirsh & Co., 197 F. Supp. 111 (the court holding that § 29(a) of the 1934 Act precluded the enforcement of an agreement to arbitrate future controversies). The latter decision presents one of the best-reasoned extensions of the *Wilko* rule to an action brought under the 1934 Act. *See also* 26 ALR FED. 500 § 3.

37 *See, e.g.,* Wilko v. Swann, 346 U.S. at 439-40 (Frankfurter, J., dissenting); Scherk v. Alberto-Culver Co., 417 U.S. at 532 (Douglas, J., dissenting); Reader v. Hirsh & Co., 197 F. Supp. at 116. *See also* Note, *Judicial Review of Arbitration Awards on Merits,* 63 HARV. L. REV. 681 (1950); Note, *Enforceability of Arbitration Agreements in Fraud Actions under the Securities Act,* 62 YALE L. J. 985, 996-97 (1953).

38 15 U.S.C. § 78aa (1970). The text provides:

> The district courts of the United States, the Supreme Court of the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or to enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, sec. 225 and 347). No costs shall be assessed for or against the commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

Compare note 15 *supra.*

39 Reader v. Hirsh, 197 F. Supp. at 116. *See also* Note, *Enforceability of Arbitration Agreements in Fraud Actions under the Securities Act,* 62 YALE L.J. 985, 996-97 (1953).

forcement of such an agreement would prevent the securities purchaser from electing a remedy after all the relevant facts were known. The remedial options available under the Securities Acts would be denied to the investor. He would necessarily assume the risk that the substantive and procedural approximations of the arbitration process would operate to his disadvantage.[40]

By eliminating his choice of remedies in an agreement to arbitrate future disputes, the securities purchaser incurs a substantial detriment. The arbitration agreement, while depriving him of his right to seek legal redress, provides the buyer with no compensating rights. Most stock exchanges require their members to arbitrate upon the request of nonmembers. Moreover, the only circuit to confront the matter held that a nonmember may invoke the rules of a stock exchange against a member.[41] Consequently, an investor needs no agreement in advance to require a broker to arbitrate a particular claim. Thus, an arbitration agreement made before any dispute arises only operates to the seller's advantage. Furthermore, it precludes the investor from ever invoking the special remedies of the Securities Acts against the broker. In depriving the plaintiff of his freedom to choose a remedy, contractual arbitration provisions obstruct his right to secure a maximum recovery.[42]

Thus, an agreement to arbitrate future disputes puts the investor at a decided disadvantage. He loses the substantive and procedural protections of the Securities Acts. The securities purchaser is further denied his election of remedies. Consequently, the very nature of the arbitration process influences the final outcome.[43]

B. *Exceptions*

The judicial preference for the Securities Acts was thus first stated in *Wilko* and was subsequently extended to similar situations under the 1934 Act.[44] Besides this extension, however, two limitations have been placed on the application of the *Wilko* rule. First, several courts have ruled that arbitration agreements made subsequent to the development of a dispute are not void. In these cases, the securities purchaser, fully aware of his right to resort to the legal process, voluntarily agreed to arbitrate an existing controversy.[45] This restriction, sug-

40 197 F. Supp. at 116.

41 Axelrod & Co. v. Kordick, Victor & Neufeld, 451 F.2d 838, 842-43 (2d Cir. 1971). In *Axelrod,* a member of the New York Stock Exchange brought an action against a nonmember broker. It alleged misrepresentation in violation of the 1933 and 1934 Acts. The nonmember moved to stay the proceedings pending the outcome of an arbitration proceeding. The court affirmed the district court's decision to stay the legal proceedings.

42 Boyd v. Grand Trunk Western RR., 383 U.S. 263, 266 (1949). The Court held the nonwaiver provision of the Federal Employer's Liability Act voided a venue-limiting agreement between employer and employee.

43 Bernhardt v. Polygraphic Company of America, Inc., 350 U.S. 198, 203 (1956).

44 *See* note 36 *supra.*

45 *See, e.g.,* Murtagh v. University Computing Co., 490 F.2d 810, 816 (5th Cir. 1974) (The court explained, "Notwithstanding the provisions of the securities laws expressly voiding any private agreement waiving compliance with the provisions of the laws, settlements of claims arising from acts which are violations of the securities laws are not void as a matter of law. . . ."); Pearlstein v. Scudder & German, 429 F.2d 1136, 1143 (2d Cir. 1970) (The Second Circuit remarked, "the remedial right of access to the courts after an active controversy has arisen can be waived knowingly in favor of arbitration." In this case, the plaintiff did not knowingly waive his rights under the Securities Acts. The court found an apparent lack of any inducement to the plaintiff to give up his rights and thus determined that his waiver was not knowing.); Moran v. Paine, Webber, Jackson, & Curtis, 389 F.2d 242, 246 (3d Cir. 1968); Reader v. Hirsh & Co., 197 F. Supp. at 117.

gested by the majority in *Wilko*,[46] was re-emphasized by Justice Jackson in his concurring opinion.[47] The limitation is grounded in the recognition that an investor's bargaining power increases once a dispute has arisen. Hence, the investor-plaintiff will receive some consideration for the detriment he incurs by submitting his claim to arbitration. The securities purchaser in such a case no longer needs to rely on the protections of the Securities Acts.

The second limitation to the *Wilko* doctrine concerns arbitration agreements entered into by members of a stock exchange. Section 28(b) of the 1934 Act expressly grants stock exchanges the power to make rules governing the settlement of disputes between members.[48] Consequently, member firms,[49] allied members,[50] and member employees[51] have been required to arbitrate. Even in cases where a nonmember invokes the stock exchange rules, arbitration has been compelled.[52] In general, the decisions in these cases reaffirm the original intent of the securities laws to protect securities purchasers. Thus, brokers have been denied the right to secure the protections of the 1933 and 1934 Acts.[53]

V. The Judicial Preference Reconsidered

A. *Frankfurter's Dissent*

The judicial preference for the Securities Acts has not developed unopposed over the last quarter-century. Early opposition appeared in Justice Frankfurter's dissent in *Wilko*.[54] He objected to the majority opinion because it ignored the

46 346 U.S. at 438.

47 *Id.* (Jackson, J., concurring).

48 15 U.S.C. § 78 bb (1970). Subsection (b) provides:

> (b) Nothing in this chapter shall be construed to modify existing law (1) with regard to the binding effect on any member of any exchange of any action taken by the authorities of such exchange to settle disputes between its members, or (2) with regard to the binding effect of such action on any person who has agreed to be bound thereby, or (3) with regard to the binding effect on any such member of any disciplinary action taken by the authorities of the exchange as a result of violation of any rule of the exchange, insofar as the action taken is not inconsistent with the provisions of this chapter or the rules and regulations thereunder.

49 Brown v. Gilligan, Will & Co., 287 F. Supp. 766 (S.D.N.Y. 1968). There a fourth-party defendant moved for an order staying the action brought by the fourth-party plaintiff until arbitration was had between them. Both parties were members of the American Stock Exchange. The court held that the 1933 and 1934 Acts do not void stock exchange rules requiring members to arbitrate their disputes; In re Revenue Properties Litigation, 451 F.2d 310 (1st Cir. 1971). In this case, the arbitration agreement between the two American Stock Exchange members bore no relation to any dealings between them. Although it arose solely from the rules of the stock exchanges, the court found that the defendant could require the plaintiff to submit the dispute to arbitration.

50 Coenen v. R. W. Presspick & Co., 453 F.2d 1209 (2d Cir. 1971). The claim in *Coenen* involved an action by an allied member of the New York Stock Exchange against a member firm. The plaintiff sought to recover for an alleged refusal to transfer his stock free of restrictive legend. The defendant moved to stay the proceedings pending arbitration. The court held that the claim was arbitrable under the New York Stock Exchange constitution.

51 Dickenstein v. duPont, 443 F.2d 783 (1st Cir. 1971). There an employee was held bound by his application for approval of employment to the New York Stock Exchange. The application included a provision to arbitrate disputes. It was signed by both the employee and the brokerage firm.

52 *See* note 41 *supra*.

53 *See, e.g.*, Coenen v. R. W. Presspick & Co., 453 F.2d 1209, 1213 (2d Cir. 1972); Axelrod & Co. v. Kordick, Victor & Neufeld, 451 F.2d 832, 842-43 (2d Cir. 1971); Brown v. Gilligan, Will & Co., 287 F. Supp. 766, 772 (S.D.N.Y. 1968).

54 346 U.S. 427, 439-40 (1953) (Frankfurter, J., dissenting).

congressional mandate of the United States Arbitration Act to enforce arbitration agreements. Frankfurter maintained that the Arbitration Act had been enacted to afford a speedier, more economical, and more effective enforcement of rights than could be obtained by litigation. He argued that the 1933 Act should not be construed to deny these benefits, absent a showing that arbitration would jeopardize the plaintiff's rights.

Frankfurter further argued that arbitrators could not disregard the law. The failure to observe the law, he maintained, "would . . . constitute grounds for vacating the award pursuant to § 10 of the Federal Arbitration Act."[55] Frankfurter also asserted that judicial review could be obtained of even the informal opinion of the arbitrator. If the record failed to indicate a judicially acceptable interpretation of the law, the award could be upset in a legal proceeding.

Frankfurter also recognized that a case such as *Wilko* could involve an instance of overreaching between parties not bargaining at arm's length.[56] Such a situation demanded the invalidation of the provision as unconscionable. It did not, however, warrant a general limitation on the Arbitration Act by the nonwaiver provision of the 1933 Act.[57]

B. *Stevens' Dissent*

The most persuasive argument levied against the *Wilko* doctrine was articulated by Judge Stevens (now Justice Stevens) in his dissent in *Alberto-Culver v. Scherk*.[58] This case involved an international contract dispute. Alberto-Culver entered into a contract to purchase the assets of a foreign business owned by Scherk. The agreement provided for the settlement of disputes by arbitration before the International Chamber of Commerce. Alberto-Culver subsequently alleged that Scherk had violated rule 10b-5 in the transaction. The defendant moved to stay the proceedings in the district court pending the outcome of arbitration. The court dismissed Scherk's motion. The Seventh Circuit affirmed the district court's decision, relying on the *Wilko* doctrine.[59]

Stevens performed an exacting analysis of the 1934 Act in rejecting the application of the *Wilko* rule to *Alberto-Culver*. Although acknowledging the substantial similarity between the language of § 14 of the 1933 Act[60] and § 29(a) of the 1934 Act,[61] he maintained that the majority in *Wilko* took great license in reading § 14. Stevens contended that the text of § 14 does not support the majority's restrictions pertaining to agreements reached prior to a controversy. He argued that the language precluding the waiver of "compliance with any provi-

55 *Id.* at 440 (Frankfurter, J., dissenting, quoting Wilko v. Swann, 201 F.2d 439, 445 (2d Cir. 1953)).

56 Frankfurter was not convinced, however, that *Wilko* involved an unconscionable contract provision. 346 U.S. at 440 (Frankfurter, J., dissenting).

57 346 U.S. at 440 (Frankfurter, J., dissenting).

58 484 F.2d 611, 615-20 (7th Cir. 1973) (Stevens, J., dissenting), *rev'd* 417 U.S. 506 (1974).

59 *Id.* at 615.

60 *See* note 13 *supra.*

61 15 U.S.C. § 78cc (1970). The section states: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void." *Compare* note 13 *supra.*

sion of this subchapter" could have been limited to the substantive provisions of the 1933 Act without including the remedy provisions.[62]

Stevens further urged that § 29(a) of the 1934 Act does not require the invalidation of all arbitration agreements. Essentially, this provision prohibits a plaintiff from waiving a defendant's compliance with any "provision" of the Act. Section 27 of the 1934 Act[63] authorizes a plaintiff to initiate a civil suit in federal district court. No language in the Act, Stevens asserted, obliges the defendant to comply with this section. Thus, the enforcement of a contractual arbitration clause waives the plaintiff's right to sue rather than the defendant's right to comply with the Act. An arbitration agreement, therefore, can be enforced, according to Stevens, yet remain consistent with a literal interpretation of §§ 27 and 29(a). Such a construction, however, does conflict with the meaning attributed to § 14 of the 1933 Act by the Supreme Court in *Wilko*, but that interpretation relied more on the public policy expressed in the 1933 Act as a whole than on the text of the statute.[64]

C. *Stewart's Majority Opinion in* Alberto-Culver

The Supreme Court agreed with Judge Stevens to the extent that it decided to reverse the Seventh Circuit in *Scherk v. Alberto-Culver Co.*[65] A five-four majority held that Alberto-Culver was bound by its arbitration agreement and had waived its right to sue under the securities laws. Thus, a new exception to the *Wilko* doctrine was created for arbitration clauses included in international agreements.

The Court, however, did not adhere to Judge Stevens' reasoning. Justice Stewart, the author of the majority opinion, found the *Wilko* exception to the Arbitration Act "simply inapposite."[66] Stewart reasoned that orderly and predictable international business relations require a prior agreement determining the law and forum applicable to disputes arising under contracts.[67] In international securities dealings, he observed, a seller can resort to a foreign court and effectively check an American buyer's protections under the Securities Acts.[68] Finally, Stewart concluded that the invalidation of the arbitration clause would reflect a "parochial concept" of the superiority of American justice.[69]

Stewart specifically distinguished *Alberto-Culver* from *Wilko* on the basis of its character as an international agreement. In addition, however, he maintained that a "colorable argument" could be made that *Wilko* should not control in any case based on the 1934 Act.[70] Stewart noted that neither § 10(b) nor rule 10b-5 provides an express private right of action. By contrast, the relevant law in *Wilko*, § 12(2) of the 1933 Act, gives the defrauded purchaser a private civil remedy. He emphasized that the court in *Wilko* found this statutory private

62 484 F.2d at 618 n. 7 (Stevens, J., dissenting).
63 *See* note 38 *supra.*
64 484 F.2d at 618 (Stevens, J., dissenting).
65 417 U.S. 506 (1974).
66 *Id.* at 517.
67 *Id.*
68 *Id.* at 518.
69 *Id.* at 519.
70 *Id.* at 513.

cause of action significant.[71] He also compared the difference between the jurisdictional provisions of the Securities Acts. Whereas the 1934 Act limits jurisdiction to the federal district courts, the 1933 Act allows a plaintiff to bring suit in any court of competent jurisdiction. Stewart determined that this difference acted as an important restriction on the plaintiff's choice of forum under the 1934 Act.[72]

Stewart's distinction failed to offer substantial reasons for limiting the *Wilko* doctrine to cases brought under the 1933 Act. Stevens made a much more convincing argument for eliminating the application of the *Wilko* rule in all but a few instances under the 1934 Act.[73] Stewart's remarks deserve attention, however, in that they reflect the attitude of five Supreme Court justices. Stevens, moreover, has subsequently replaced Justice Douglas, a dissenter in the *Alberto-Culver* opinion, on the bench. The Court may now be willing to make more than a "colorable argument" restricting the *Wilko* rule to actions brought under the 1933 Act. Consequently, uncertainty exists in an area of the law once thought to be settled.

VI. An Opportunity Lost

A. *Uncertainty Resolved*

Thus, the *Weissbuch* case provided the Seventh Circuit with an opportunity to reassess the applicability of the *Wilko* rule to disputes arising under the 1934 Act. The court noted that the Supreme Court's decision in *Alberto-Culver* "left open the question of whether an arbitration clause would be enforced against a claim arising under rule 10b-5 where there were no international dimensions involved."[74] It looked to Stewart's retort to the dissent's criticism of the talismanic quality of the majority's "international contract" exception: "Concedely situations may arise where contacts with foreign countries are so insignificant or attenuated that the holding in *Wilko* would meaningfully apply."[75] The Seventh Circuit found Stewart's recognition of *Wilko* in his response dispositive of the issue. Thus, the court upheld the extension of the *Wilko* doctrine to the 1934 Act.

B. *Public Policy*

The overriding concern in both *Wilko* and *Alberto-Culver* involved the conflict of the Arbitration Act with the securities laws. The Seventh Circuit realized that it faced a similar issue in *Weissbuch*. Clearly, the circumstances of the case

71 *Id.* at 513-14.

72 *Id.* at 514. *Compare* § 22(a) of the 1933 Act, note 15 *supra, with* § 27 of the 1934 Act, note 38 *supra.*

73 Stevens argued for a flexible application of the *Wilko* rule to actions brought under the 1934 Act. He interpreted the court's reading of § 14 of the 1933 Act in *Wilko* as based on the public policy expressed in the statute as a whole. He granted that § 29(a) of the 1934 Act should likewise be extended beyond its literal meaning in a case which would defeat the purpose of the Act. Stevens maintained that *Alberto-Culver* clearly did not involve such an incident. 484 F.2d at 619 (Stevens, J., dissenting).

74 558 F.2d at 834.

75 417 U.S. at 518 n.11.

in *Weissbuch* more closely resembled *Wilko* than *Alberto-Culver*. Since the court found that *Alberto-Culver* had not limited *Wilko* to actions brought under the 1933 Act, it disposed of *Weissbuch* with little analysis.

Consequently, the Seventh Circuit acquiesced in the subordination of the Arbitration Act to the Securities Acts. By adhering to the judicial preference for the securities laws, the court indicated that its primary concern remained the protection of securities purchasers.

VII. Conclusion

A. *Bankrupt Analysis*

From a jurisprudential viewpoint, *Weissbuch* and similar cases that have applied the *Wilko* rule to controversies under the 1934 Act lack a sound analytical basis. In these cases, the courts strive to protect an investor from the superior bargaining power of an institutional broker. Often the specific provisions of the Act are disregarded in order to achieve this end.[76] The cryptic reasoning of Justice Stewart in *Alberto-Culver*—first challenging the legitimacy of applying the *Wilko* doctrine under the 1934 Act and then, without resolving the issue, creating an undefined "international contract" exception to it—demonstrates the problematic nature of this analysis.[77]

B. *Adhesion Contract Doctrine*

The problematic reasoning of the courts in cases like *Weissbuch* indicates the need for a new analytical model. The adhesion contract doctrine is readily adoptable to this end. The doctrine would protect the investor from the overreaching of brokers in securities transactions. It would also provide a sound analytical basis for deciding the case.

An adhesion contract is characterized by five features.[78] First, a standardized form is used to define the relationship between the parties. Second, the forms are employed in response to the mass demand for the object of the agreement. Third, the form contracts are drafted and presented to the public; that is, the terms of the agreement are impersonally determined. Fourth, the bargaining position of the promisee greatly exceeds that of the promisor. This superiority may be achieved in many different ways. For instance, an enterprise may realize a superior bargaining position as a result of its large-scale operations in production or distribution. A security broker's superior bargaining power may arise on the basis of its greater knowledge of the securities market alone.[79] Finally, the individual promisor suffers from a relatively unequal bargaining position with regard to the promisee. If these features are combined with oppressive terms, the contract is invalidated under the adhesion contract doctrine.[80]

76 484 F.2d at 617-19 (Stevens, J., dissenting).
77 J. Corp. L. 100, 109-10 (1975).
78 Lenhoff, *Contracts of Adhesion and the Freedom of Contract: A Comparative Study in the Light of American and Foreign Law*, 36 TULANE L. REV. 481, 481-82 (1962).
79 484 F.2d at 617 n.4 (Stevens, J., dissenting).
80 *See, e.g.*, Henningsen v. Bloomfield Motors, Inc., 32 N.J. 358, 161 A. 2d 69 (1959); Campbell Soup Co. v. Wentz, 172 F.2d 80 (1948).

The adhesion contract doctrine would assure the protection of small investors. It would further allow an investor with sufficient bargaining power to limit legitimately its selection of forum in advance of a dispute. The Arbitration Act would yield to the Securities Exchange Act only when the factual circumstances so warranted. Thus, the doctrine strikes a balance between the conflict of the Acts.

C. *Simplicity*

Previous cases dealing with parties who possessed substantially equal bargaining power have fallen into one of the exceptions to the *Wilko* rule. The application of the adhesion contract doctrine, however, would dispense with the need for exceptions to the general rule. The court would consider the validity of each arbitration agreement in terms of the kind of negotiations preceding the contract and the relative bargaining power of each party. This sort of analysis allows the court both to protect small investors and to interpret § 29(a) of the 1934 Act literally. To the extent that no abusive bargaining power had been used, the Arbitration Act would be upheld.

Overall, the courts' performance in cases such as *Weissbuch* has lacked a well-defined analytical foundation. Consequently, it has been held that the 1934 Act creates a special exception to the Arbitration Act. The courts have also devised exceptions to the 1934 Act in order to enforce arbitration agreements. The courts could avoid these analytical aberrations and remove the conflict between the two national policies by adopting the adhesion contract doctrine. Unfortunately, decisions such as *Weissbuch* indicate a lack of judicial desire to do so.

Gerald M. Richardson

SECURITIES REGULATION—MERGING COMPANIES' STOCK VALUES ARE EXCLUSIVE CRITERIA IN MEASURING INJURY FROM MERGER VIOLATIVE OF § 14(a)—ATTORNEYS' FEES NOT RECOVERABLE IN FUTILE ATTEMPT TO PROVE DAMAGES RESULTING FROM SUCH VIOLATION.

*Mills v. Electric Auto-Lite**

I. Introduction

Enforcement of federal securities laws is a complex matter. The judicial acknowledgment of a private right of action under the Securities Exchange Act of 1934 has further complicated securities litigation by creating a cause of action which lacks the specifics of remedies provided by statute. It is not unnatural, therefore, for courts to try to ease the adjudicative task by resorting to simplified approaches in grappling with the uncertainties involved in private enforcement. At the same time, however, there is a danger of judicial oversimplification at the expense of equitable results.

Illustrative of the complexities involved in adjudicating federal security matters is the determination of monetary damages and compensation in a private enforcement action. It was precisely this question that confronted the Seventh Circuit Court of Appeals in its second review of *Mills v. Electric Auto-Lite Company*. *Mills* presented the court with two difficult issues: first, what factors should be considered in calculating damages resulting from a violative merger; and, second, should private plaintiffs be compensated for attorneys' fees incurred in a fruitless attempt to recover damages for a securities law violation? This comment examines the court's efforts to disentangle the intricate problems involved in answering these questions. It also analyzes the court's reasoning, in which the court contradicted its own case precedent and misinterpreted decisions rendered by the United States Supreme Court.

II. Background and Facts

On June 26, 1963, plaintiffs, minority shareholders of Electric Auto-Lite, filed a complaint[1] in the United States District Court for the Northern District of Illinois, challenging the merger of the Electric Auto-Lite Company[2] with the Mergenthaler Linotype Company[3] to form the Eltra Corporation. In their original complaint plaintiffs contended that the merger proxy statement mailed to Auto-Lite shareholders set forth the approval of the merger terms by the Auto-Lite board of directors and the board's recommendation for shareholder approval of the merger without adequately disclosing the relationship between Auto-Lite

* 552 F.2d 1239 (7th Cir. 1977), *petition for rehearing denied* June 3, 1977.

1 Plaintiffs sued on behalf of themselves and all other minority stockholders of the Electric Auto-Lite Company, and derivatively on behalf of Auto-Lite. Brief for Plaintiff at 1, Mills v. Electric Auto-Lite Co., 552 F.2d 1239 (7th Cir. 1977).

2 Auto-Lite was engaged primarily in the manufacture of automotive parts, both original equipment and replacement parts. *Id.* at 11.

3 Mergenthaler Linotype Company was engaged in the production and distribution of printing equipment. *Id.* at 8.

and Mergenthaler.[4] Plaintiffs asked that the merger, which was ultimately approved[5] at a shareholders' meeting on June 27, 1963, be declared void.

On February 4, 1964, plaintiffs filed an amended and supplemental three-count complaint resisting the merger and requesting rescission and damages. Count II[6] specifically charged that Mergenthaler, in violation of Section 14(a) of the Securities Exchange Act of 1934,[7] caused Auto-Lite to send through the mails an intentionally misleading proxy statement.

On September 26, 1967, Judge Parsons filed a memorandum opinion[8] granting plaintiffs' request for summary judgment with respect to Count II and directing the parties to proceed on the issue of appropriate relief.[9] He concluded that the proxy material was defective as a matter of law and fact, and was a direct and ultimate cause of the merger.[10] He further stated that the merger, although effectuated in violation of the law, was not automatically void. Both of these rulings were certified for interlocutory appeal.

On November 25, 1968, the Seventh Circuit agreed with the trial court's ruling that the proxy statement was deficient as a matter of law, but reversed the summary judgment ruling in the belief that a causal connection had not been demonstrated between the omission in the proxy statement and the vote approving the merger. The district court's denial of rescission was affirmed.[11]

The United States Supreme Court vacated the judgment of the Seventh Circuit and reinstated the holding of the district court.[12] The Court went on to

4 Four of the directors of Mergenthaler served on Auto-Lite's board. Mergenthaler began acquiring Auto-Lite stock in February, 1957. The district court found that Mergenthaler effectively controlled the Auto-Lite board of directors in August of 1961. Through a number of purchases and tender offers Mergenthaler acquired legal as well as practical control over Auto-Lite in March, 1962, when it achieved 53-54% stock ownership of the latter. Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 5 (N.D. Ill. April 11, 1975).

5 The holders of approximately 13% of the minority shares had to approve the merger in order to secure the two-thirds vote necessary for ratification. Mills v. Electric Auto-Lite Co., 403 F.2d 429, 432 (7th Cir. 1968).

6 This complaint contained, in addition to Count II, a charge of common law fraud (Count I) and a claim that the merger was ultra vires under Ohio law (Count III). The only issue before the Seventh Circuit was Count II, the § 14(a) claim. Brief for Defendant at 5.

7 15 U.S.C. § 78(n)(a) (1970) (hereinafter cited as § 14(a)). Section 14(a) provides:

> It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, 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, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to section 78(l) of this title.

8 Mills v. Electric Auto-Lite Co., 281 F.Supp. 826 (N.D. Ill. 1967).

9 In his opinion, Judge Parsons also referred the case to a master for consideration of appropriate relief. *Id.* at 831.

10 The proxy material was a pamphlet of 108 pages. Statements on pages two and three indicated that the Auto-Lite board endorsed the merger. One of these endorsements stood out in type which was bigger and blacker than the surrounding text. It said, "The Board of Directors has carefully considered and approved the terms of the merger and recommends that the shareholders vote to approve the plan of merger." One reference to Mergenthaler's ownership of 54% of the stock appeared on page two, but this fact was not given the same emphasis as the recommendation. Other information indicating a close relationship between some of the directors of Auto-Lite and Mergenthaler appeared many pages later. Mills v. Electric Auto-Lite Co., 403 F.2d 429, 433 (7th Cir. 1968).

11 *Id.* at 435-36.

12 Justice Harlan, speaking for the majority, said that the deficiency in the proxy solicitation paper was material, and that "[w]here there has been a finding of materiality, a shareholder has made a sufficient showing of causal relationship between the violation and the

consider the relief to which plaintiffs were entitled, and held that the merger did not need to be set aside as a result of the deception in the proxy statement.[13] The opinion stated that monetary relief[14] was a possibility if the merger resulted in a reduction of the earnings or earnings potential of the minority shareholders' interest. If, however, commingling of the assets and operations of the merged companies made it impossible to establish direct injury from merger, financial relief could be predicated on a determination of the unfairness of the merger terms at the time they were approved.[15] The Court made it clear that by citing these theories of damages it did not mean to exclude others, and that, regardless of the measurement employed, damages were to be recovered only to the extent shown.[16]

Finally, the Court ruled that plaintiffs should be reimbursed by the corporation for litigation expenses and attorneys' fees and remanded the case to the district court to determine the appropriate relief.

With the case before him again, the trial judge first held the merger should not be rescinded.[17] After a three month trial without a jury,[18] he then concluded in an unpublished opinion[19] that the merger terms were unfair to plaintiffs and awarded them $1,233,918.36 as well as approximately $740,000 in prejudgment interest.[20] The court further held that plaintiffs' attorneys should be compensated out of this award.

Both parties appealed. Plaintiffs contended that the district court used an improper method to calculate damages and erred in assessing attorneys' fees against the money award. Defendants insisted that no damages were recoverable because the merger was fair.

The Seventh Circuit again reversed the district court by holding that the merger terms were equitable to Auto-Lite's minority shareholders. The court concluded that plaintiffs were not entitled to damages, nor were they entitled to be compensated for attorneys' fees and other expenses incurred since the Supreme Court's earlier decision in *Mills*.

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injury for which he seeks redress if, as here, he proves that the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." 396 U.S. 375, 385 (1970).

13 The Court concluded that such action could be ordered if warranted by equitable considerations. *Id.* at 388.

14 The Court found that in this case the misleading aspect of the solicitation did not relate to the terms of the merger. However, "[w]here the defect in the proxy solicitation relates to the specific terms of the merger, the district court might appropriately order an accounting to ensure that the shareholders receive the value that was represented as coming to them." *Id.* at 388.

15 *See* text accompanying notes 31-46 *infra* for an explanation of how these measures of damages are applied.

16 396 U.S. 375, 389 (1970).

17 On January 10, 1972, Judge Parsons entered findings of fact and conclusions of law determining that rescission of the merger would not be an appropriate remedy. Mills v. Electric Auto-Lite Co., (1972) Fed. S. L. Rep. (CCH) ¶ 93,354. On May 22, 1972, by memorandum opinion, he established the class of potential plaintiffs, which class he modified in his April 11, 1975, opinion. Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 39-45 (N.D. Ill. April 11, 1975).

18 The trial lasted from November 11, 1973, to February 19, 1974.

19 Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559 (N.D. Ill. April 11, 1975).

20 The interest was computed at 5% per annum. *Id.* at 45.

III. Section 14(a) of the Securities Exchange Act of 1934

Section 14(a) of the Securities Exchange Act makes it unlawful to violate proxy[21] rules and regulations promulgated by the Securities and Exchange Commission (SEC). Such regulations are directed at requiring disclosures that will assure that stockholders' meetings are attended by parties informationally competent to deliberate on matters presented.[22] The purpose of the section is to prevent management or others from obtaining authorization for corporate action by means of deceptive or inadequate proxy solicitations.

The SEC was empowered by Congress to implement the requirements of § 14(a) through the use of injunctions and other criminal sanctions.[23] It became apparent, however, that the SEC, acting alone, was unable effectively to prevent all proxy abuses.[24] The language of § 14(a), however, provided no express right to individual investors to enforce the § 14(a) proscriptions. The Supreme Court filled this enforcement gap in *J. I. Case Co. v. Borak*,[25] in which the Court ruled that the availability of derivative and representative actions by individual shareholders was implied by § 14(a) as a necessary supplement to SEC enforcement.[26] The specific formulation of remedies in cases of private enforcement was left to the district courts.[27]

Case law emerging from the Supreme Court and lower federal courts has established that a private investor may obtain three general types of remedies for the violation of securities laws: injunction,[28] rescission,[29] and monetary damages.

21 A proxy is properly the authority given by a shareholder to another to vote for him at a shareholder's meeting. The term is also used to refer to the instrument or paper which is evidence of the authority of the agent and also to the agent or proxy holder who is authorized to vote. W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2050 (rev. perm. ed. 1976).

22 *Id.* at § 2052.1.

23 The primary enforcement device of the Act is the injunction, which empowers the SEC to institute suit in federal district courts to enjoin activities which constitute violations of the Act. *See* 15 U.S.C. § 78(u)(d) (1975). Although infrequently employed, criminal sanctions are also available under 15 U.S.C. § 78(ff) (1970).

24 In J. I. Case Co. v. Borak, 377 U.S. 426 (1964), the SEC advised the Court that it examined 2,000 proxy statements annually. The Court noted this, saying, "[t]ime does not permit an independent examination of the facts set out in the proxy material and this results in the Commission's acceptance of the representations contained therein at their face value, unless contrary to other material on file with it." *Id.* at 432.

25 377 U.S. 426 (1964).

26 By reaching this conclusion the Court overruled Howard v. Hurst, 238 F.2d 790 (2d Cir. 1956), *cert. denied,* 353 U.S. 937 (1957), in which the Second Circuit reasoned that Congressional failure to articulate specifically that a substantive civil right on behalf of a corporation is enforceable in a derivative action by a shareholder negated its existence.

27 Private relief is unavailable under § 14(a) unless the complaining party can show that the proxy solicitation was materially false or misleading and that it caused stockholder approval of the solicitation. For an explanation of causation *see* Mills v. Electric Auto-Lite, 396 U.S. 375, 385 (1970). For a case defining materiality *see* Northway, Inc. v. TSC Industries, Inc., 512 F.2d 324 (7th Cir. 1975), *rev'd,* 426 U.S. 438 (1976). A note appended to SEC Rule 14a-9, 17 C.F.R. § 240, 14a-9 (1973) gives examples of what may be considered misleading.

28 Although the injunction has been the characteristic remedy employed by the SEC, it has been more difficult for the private plaintiff to obtain such relief because a stricter burden of proof is required. For an explanation of the prerequisites of this equitable remedy *see* Dunn v. Decca Records, Inc., 120 F.Supp. 1 (S.D. N.Y. 1954), Mack v. Mishkin, 172 F.Supp. 885 (S.D. N.Y. 1959) and Sherman v. Posner, 266 F.Supp. 871 (S.D. N.Y. 1966). *See also* Note, *Private Enforcement of the Federal Proxy Rules: Remedial Alternatives,* 15 WM. & MARY L. REV. 286 (1973).

29 Rescission was specifically authorized as a remedy by the *Mills* Court, which ordered lower federal courts to set aside mergers if a court of equity would conclude, from all the

At issue in the Seventh Circuit decision in *Mills* was a claim for monetary damages.[30]

A. *Monetary Damages as a Private Remedy*

The Supreme Court in its *Mills* decision expressly sanctioned the recovery of monetary damages for securities laws violations. In so doing, it cited two possible, though not exclusive, theories for computing such damages: the "reduction of earnings or earnings potential" theory and the "fairness" theory. In *Mills,* the matter of relief was not before the Supreme Court, and its dicta were designed only to furnish rough guidelines for the fashioning of an appropriate remedy. Consequently, lower federal courts have had the difficult task of applying either theory to specific cases.

Under the "earnings" theory, courts generally attempt to discern, by looking at the post-merger performance and activities of the acquired entity in comparison to the other components of the acquiring firm, whether the value placed on the acquired shares at the time the merger took place was fair to those shareholders possessing them.[31] Since the "earnings" theory depends primarily upon an examination of post-merger data, relief based upon such a measure is frequently difficult or impossible to grant. Often proof of post-merger occurrences is unavailable to plaintiffs because they are unable to obtain company records. Even if available, such records may be for internal purposes only, and thus of questionable reliability. Furthermore, commingling of the assets and operations due to the consolidation makes it difficult to establish the direct injury caused by the transaction. It is also virtually impossible to determine to what degree the injuring party caused the post-transaction occurrences. Thus, when one or more of these circumstances are present, the determination of post-merger events becomes so speculative that the theory's utility for assessing damages is severely impaired.[32]

Consequently, courts frequently rely on the "fairness" theory, which disregards post-merger events. Under this method, money damages are recoverable to the extent that the value of what is received by the seller at the time of the merger is not commensurate with what he would have received at such time had there been no fraudulent conduct.

This damage figure is often arrived at through a comparison of exchange ratios. The exchange ratio is the ratio of the number of shares of the acquiring entity given in exchange for each share of stock possessed by shareholders of the

circumstances, that it would be equitable to do so. The Court noted that, in practice, the objective fairness of the proposal would seemingly be determinative of liability. One commentator has pointed out that, ironically, the same "fairness" formula used to arrive at a decision not to rescind may render proof of monetary loss virtually impossible. Thus, the plaintiff shareholder may be assured a technical judgment of liability but denied any tangible economic relief. *See The Supreme Court, 1969 Term,* 84 HARV. L. REV. 211, 214 (1970). *See also* Note, *Causation and Liability in Private Actions for Proxy Violations,* 80 YALE L. REV. 107, 128, n. 86 (listing factors to consider in granting rescission).

30 An injunction had never been a viable remedy since the plaintiffs did not file their first complaint until one day before the scheduled shareholders' meeting. Rescission had been sought by plaintiffs but their request was rejected in 1964 by the district judge, whose findings were affirmed by the Seventh Circuit in 1968 and the Supreme Court in 1970.

31 *See* 552 F.2d 1239 at 1242.

32 Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 17 (N.D. Ill. April 11, 1975).

acquired entity. If the actual exchange ratio used in the merger, as compared to a ratio computed assuming no fraud, overvalues the stock given by the acquiring entity or undervalues the shares surrendered by the acquired entity, then the actual exchange ratio is inequitable and relief may be obtained.[33]

The complexity in this technique lies in determining what the ratio would have been absent the fraudulent conduct. Financial experts[34] note that in practice, when exchange ratios are determined, several quantitative components typically receive emphasis. These factors include earnings, the growth rate of earnings, dividends, market value, book value, and net current assets.[35]

Case law supports the approach which considers a number of quantitative factors in determining fair exchange ratios.[36] The Third Circuit sustained such a procedure in *Levin v. Great Western Sugar Co.*[37] There, the plaintiff, a shareholder of Great Western Sugar, commenced an action to enjoin the merger of that company and the Colorado Milling and Elevator Company. Plaintiff charged that defendants violated both § 10(b)[38] of the Securities Exchange Act and New Jersey state law. She also contended that the merger terms were unfair.

The court rejected her complaints under both state and federal law. In considering plaintiff's unfairness allegation, the court of appeals inspected a variety of factors, including earnings per share, dividends, and market values. Upon examination of these factors the Third Circuit concluded, as had the lower court, that the merger terms were equitable.

Likewise, in *de Haas v. Empire Petroleum Co.*,[39] the Colorado district court was asked to examine a 1966 merger which was alleged to have been constructively fraudulent under rule 10b-5[40] because the merger exchange ratio was unfair. The trial court rejected complainant's allegations and in the process said that the fairness issue:

> is one of fact, and all of the surrounding circumstances are relevant in assessing the fairness of the merger terms . . . Furthermore, *all* relevant value figures including book value, net asset value, going concern value and market value are pertinent to the issue of the fairness of a merger exchange ratio.[41]

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33 Dasho v. Susquehanna Corp., 461 F.2d 11,-27 (7th Cir.), *cert. denied,* 408 U.S. 925 (1972).

34 *See* WESTON, FRED & BRIGHAM, MANAGERIAL FINANCE at 749 (1975).

35 These terms may be defined as follows: Earnings are net income, after income tax, available to stockholders; dividends represented the actual income received by stockholders; market value refers to the price of a firm's stock; book value of stock is equal to the net worth (the capital and surplus of a firm) of the corporation divided by the number of shares outstanding; net current assets are current assets minus current liabilities. Net current assets per share are likely to have an influence on mergers because they represent the liquidity that may be obtained from a company in a merger.

36 *See* FLETCHER, *supra* note 21, at § 7160.

37 406 F.2d 1112 (3d Cir. 1969).

38 15 U.S.C. § 78(j)(b) (1970) makes it unlawful for a person to use or employ any manipulative or deceptive device in contravention of rules and regulations prescribed by the Securities and Exchange Commission for the protection of investors.

39 300 F.Supp. 834 (D.C. Col. 1969), *aff'd in part and rev'd in part,* 435 F.2d 1223 (10th Cir. 1970).

40 SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973) prohibits any device, scheme, or artifice to defraud in connection with the purchase or sale of any security.

41 300 F.Supp. 834, 837 (D.C. Colo. 1969) (emphasis added).

On appeal, the Tenth Circuit affirmed[42] this portion of the lower court's opinion and, thus, like the Third Circuit and many financial experts, acknowledged the importance of looking to a multiplicity of factors in determining accurate exchange ratios.

These cases illustrate the importance of examining all relevant quantitative factors. They provide little guidance, however, as to the weight each individual element is to be given in reaching an equitable exchange ratio. Although attempts have been made to determine statistically the relative weights that should be assigned to quantitative factors in actual merger cases, these attempts have proven unsuccessful. This is because no two mergers are exactly alike; each merger involves different parties with their own strengths and weaknesses, and each is consummated in a different way.

This inability to rank these various factors suggests that qualitative elements should also be considered.[43] The merger should be examined to see whether it will have a synergestic effect, that is, whether more profits will be generated by the consolidated company than the total that could have been achieved by the individual firms operating separately. The amount of operating leverage,[44] or the percentage change in operating income that results from a percentage change in sales for each company should be inspected, since a high degree of leverage implies that a relatively small change in sales will result in a large change in profits.[45] The management quality of the individual firms contemplating the merger as well as the firms' position in their respective industries deserves attention because, like the other factors enumerated, these elements may have an overriding influence on the ultimate merger terms. Often the most important business considerations are not reflected in historical quantitative data.[46]

1. The Judicial Analysis of Damages in *Mills*

a. *Earnings Theory*

Although plaintiffs presented formulas and experts[47] for computing damages under both the "earnings" theory and the "fairness" theory, they vigorously requested application of the former. The plaintiffs' "earnings" formulation reflected their perception of the reasons for the merger. They maintained that Mergenthaler proposed the long-conceived plan[48] in order to transfer funds from

42 The Tenth Circuit vacated a portion of plaintiffs' award (punitive damages) that related to a separate illegal merger occurring in 1962. 435 F.2d 1223, 1232 (10th Cir. 1970).

43 *See* WESTON, FRED & BRIGHAM, *supra* note 34, at 753.

44 Another type of leverage that deserves examination is financial leverage which is defined as the ratio of total debt to total assets.

45 WESTON, FRED & BRIGHAM, *supra* note 34, at 60.

46 *Id.* at 753-4. *See also* Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 15 (N.D. Ill. April 11, 1975).

47 George Sorter, professor of accounting at the University of Chicago, appeared for plaintiff and devised a formula for damages under the earnings theory. Erwin Nemmers, professor of finance at Northwestern University, did the same regarding the fairness theory.

48 Plaintiffs contended that Mergenthaler's initial proposal of merger terms was presented to the Auto-Lite board on April 5, 1963, and proposed an exchange of one share of Auto-Lite for 1.8 shares of Mergenthaler convertible preferred stock with a dividend of $1.40 per share, or $2.50 per share on the 1.8 exchange basis. Also, there was to be a concurrent tender offer by Mergenthaler for up to 50,000 shares of Auto-Lite stock at a price up to $62 a share. These terms were later modified.

Auto-Lite to other divisions of Eltra without interference from Auto-Lite's minority shareholders, and to more fully enjoy the benefits of Auto-Lite's increased earnings and continuing liquidity.[49]

The district court rejected plaintiffs' "earnings" theory of damages because they: (1) failed to account for economies achieved through the combined operations, (2) examined records which were deficient because they inadequately reported the actual expenses incurred by the former Auto-Lite divisions, and (3) made questionable assumptions regarding the removal and distribution of Auto-Lite's assets and earnings. More importantly, the trial court also noted the substantial commingling of the assets and operations of the two companies after the merger. This made it difficult to establish if, or to what extent, injury was caused by the transaction. Consequently, the district court concluded that plaintiffs' version of the Eltra Corporation's post-merger activities could not serve as a basis for granting relief.[50]

The Seventh Circuit, in its review of *Mills,* agreed with the district court's reasons for disallowing plaintiffs' "earnings" formulation. It also rejected plaintiffs' theory that the former Auto-Lite minority shareholders were injured by Eltra's shifting of liquid assets and earnings from Auto-Lite to other divisions. The court found that after the merger the interests of the former Auto-Lite shareholders and former Mergenthaler shareholders coincided, so that Eltra's management could not take action benefiting one group without helping the other.[51]

Furthermore, the court of appeals sustained the lower court's finding that significant commingling of assets had occurred and thus held that the district court did not abuse its discretion in refusing to award damages based on post-merger data.

b. *Fairness Theory*

Once the district court concluded that application of the "earnings" theory was not feasible it turned to the "fairness" method and examined the equity of the merger at the time it took place.[52] The lower court focused its analysis on the quantitative factors of market value, earnings, book value and dividends as of the time of the merger, as well as on certain qualitative factors. After inspecting market values for a customary five-year period prior to the merger, however,

49 Liquidity refers to a firm's cash position and its ability to meet maturing obligations. Auto-Lite had nearly $18 million in cash and marketable securities before the merger. Brief for Plaintiffs at 105.

50 Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 25-7 (N.D. Ill. April 11, 1975).

51 552 F.2d 1239, 1242 (7th Cir. 1977).

52 Under the terms of the merger agreement the exchange ratio was set at 1.88; i.e., a minority shareholder of Auto-Lite received 1.88 preferred shares of Eltra for each share of Auto-Lite common that he had held. Eltra preferred shares were convertible into common shares on a one-to-one basis for the first two years and on a slightly decreasing basis for the next three years. Auto-Lite minority shareholders received stock worth $58.39 (1.88 x $31.06) a share while Mergenthaler shareholders received stock worth $25.25. Eltra common was to pay a dividend of $1 per share and Eltra preferred a dividend of $1.40 a share. Thus, the dividend received by the Auto-Lite minority shareholders was increased as a result of the merger from $2.40 (dividend received from one share of Auto-Lite common) to $2.63 (1.88 x $1.40). *Id.* at 1241-42.

the lower court concluded that "inter-company" transactions and Auto-Lite's program of diversification caused the stock prices of both companies to be unreliable factors which could not play an important part in the fairness analysis.[53]

The court also discounted the role of dividends. In addition, it concluded that because of Auto-Lite's substantial liquid asset position at the time of the merger the book values of each corporation were significant, as were their comparative earnings. Finally, after examining several qualitative factors, the trial court found synergy to be present.[54]

With this information before it, the district court held that nearly all former Auto-Lite minority shareholders actually received, as a result of the merger, stock valued in the marketplace at the time of its receipt which was 225% the market value of the stock received by the former Mergenthaler shareholders. Thus, the effective exchange ratio was 2.25 to 1.

To conclude its analysis the court examined all the relevant evidence introduced at trial regarding the pre-merger histories of the two firms and their respective conditions in early 1963, and decided that the ratio of 2.35 to 1 fairly represented what was given up by the holder of one share of Auto-Lite stock as compared with what was given up by a holder of one share of Mergenthaler at the time of the merger.[55] Using a rather involved formula,[56] the court calculated that each Auto-Lite shareholder lost approximately $2.317 per share. Multiplying this figure times the number of Auto-Lite shares outstanding that were held by the minority at the time of the merger gave the total damage figure. This figure, $1,233,916.35,[57] generally conformed with alternate calculations performed by the trial judge.[58]

On appeal the Seventh Circuit rejected the lower court's analysis. It contested the trial court's decision that market values were unreliable and therefore could not play an important part in the fairness analysis. According to the Seventh Circuit, because market prices were dependable they should be relied upon exclusively in arriving at a fair merger exchange ratio.[59]

In finding that the market value of Auto-Lite's and Mergenthaler's stock at the time of the merger was accurate, the Seventh Circuit rejected certain conclusions made by the lower court and several arguments propounded by plaintiffs.

53 Plaintiffs' expert on fairness, Dr. Nemmers, felt that 1961-63 prices were unreliable because: (1) Mergenthaler caused Auto-Lite to pay out high dividends which lowered Auto-Lite's stock price and raised Mergenthaler's, (2) Auto-Lite's diversification had caused a temporary depression in its earnings which was reflected in its market price, and, (3) the network of intercompany stock transfers caused market prices to be unreliable. For a summary of these stock transfers, *see* 552 F.2d 1239, 1245 n.7 (7th Cir. 1977). *See* text accompanying notes 59-62 *infra*.

54 Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 22 (N.D. Ill. April 11, 1975).

55 The court did not explain the method it used in arriving at this figure.

56 *See* 552 F.2d 1239, 1244-45, n. 6 (7th Cir. 1977).

57 Plaintiffs' expert maintained that the fair merger ratio, based upon 1958-60 market prices, which he considered reliable, was 3.0. He contended that if such ratio was used, then 1,249,500 additional Eltra shares would have had to have been issued for a total of $36,522,-885. Adding the dividends and interest corresponding to this amount ($15,835,680) he arrived at a damages figure under the "fairness" method of $52,358,565.

In their appellate brief defendants presented a formula which indicated the merger terms were fair. This is the formula the Seventh Circuit adopted for computation of damages.

58 This congruence is surprising considering the fact that the district judge made a mathematical error such that the correct figure would have left an award of only $410,000.

59 *See* 552 F.2d 1239 at 1247-48.

Principally, the court of appeals felt that the trial court's decision to discount market values and to rely on other indicia to determine an equitable ratio rested upon an unsupported theory that inter- and intra-company stock transactions just prior to the merger adversely affected Auto-Lite's stock prices as compared to Mergenthaler's.[60] The Seventh Circuit could discern no substantial trading of stock immediately prior to the merger and no manipulation of stock prices. By comparing the price ratio of the two stocks during 1961 and 1962,[61] when there was a substantial amount of transfers, with the ratio of the first half of 1963, the court concluded that the prices were responding to factors other than inter-company transactions.

The Seventh Circuit buttressed this conclusion by arguing that even if these transfers had an impact, they were purchases which would have tended to raise rather than lower the price of the stocks that were traded. Since Auto-Lite purchases were greater than Mergenthaler trading, this would indicate that the inter- and intra-company purchases pushed the price of Auto-Lite stock upward relative to Mergenthaler stock.[62]

The court also rejected as internally inconsistent plaintiffs' argument that Mergenthaler used its control over Auto-Lite in 1961-63 to compel it to pay unusually high dividends, with the effect of depressing the price of Auto-Lite stock by draining Auto-Lite of capital and raising the price of Mergenthaler stock by giving Mergenthaler funds with which to pay higher dividends. The court declared that if the payment of higher dividends increased the value of Mergenthaler stock then it would follow that the payment of higher dividends by Auto-Lite would also increase its attractiveness on the market. Thus, the panel concluded that Auto-Lite's high dividends between 1961 and 1963 did not distort the relative market values of the two companies.[63]

Finally, the court was not convinced by plaintiffs' argument that Auto-Lite's diversification in the early 1960's temporarily depressed the price of the stock. Instead, the court considered this diversification as reason to examine the years 1960-63, because it reflected an uncertainty in Auto-Lite's future which should have been a factor in determining the merger terms.

Having justified its reliance on market values, the court then faced the problem of whether to consider other factors, including book values and earnings, which the lower court had found to be significant. Opting against such a consideration, the Seventh Circuit held:

> [W]hen market value is available and reliable, other factors should not be utilized in determining whether the merger terms were fair. Although criteria such as earnings and book values are an indication of actual worth, they are only secondary indicia. In a market economy, market value will always be the primary gauge of an enterprise's worth . . . If we were to independently assess criteria other than market value . . . we would be

60 *Id.* at 1245.
61 The ratio of the average price of Auto-Lite stock to the average price of Mergenthaler stock was 2.0 in 1961, 2.1 in 1962, and 2.1 up to May 24, 1963, the last date on which the prices were compared for purposes of the merger.
62 *See* 552 F.2d 1239 at 1246.
63 *Id.* at 1247.

> substituting our abstract judgment for that of the market . . . Such a method would be economically unsound.[64]

Choosing to consider market prices exclusively, the court was faced with selecting an appropriate interval during which time the market figures should be examined. The court concluded that the average market value of each company during the six months preceding the merger should be used in assessing fairness. These values were then plugged into a fairness formula that the court took nearly verbatim from the defendant's appellate brief. This calculation computed the incremental value resulting from the merger by comparing the pre-merger and post-merger market values of Auto-Lite and Mergenthaler stock. The result was an appreciation of $4,281,958. The court felt that in order for the Auto-Lite minority shareholders to have participated equitably in this enhancement, the exchange ratio should have been pegged at 2.16 to 1.[65] The court decided that the effective exchange ratio was 2.31 to 1.[66] Hence, the merger was fair because plaintiffs received .15 shares of Eltra common per share of Auto-Lite more than equity required.[67]

2. Analysis of the Seventh Circuit's Conclusion: Is Market Value Enough?

From the foregoing discussion it is clear that the Seventh Circuit devoted much of its time justifying the use of market values and refuting the lower court's rejection of them. In the process it usurped the district court's fact-finding responsibility. The lower court's decision to discount the reliability of market values was a factual one based upon testimony accumulated during a three-month trial. The court of appeals, in disregarding the trial court's decision, chose to ignore expert opinion introduced during the trial as well as several factual conclusions made by the lower court. In so doing, the Seventh Circuit violated the mandate of Federal Rule of Civil Procedure 52[68] which provides that findings of fact shall not be set aside unless clearly erroneous.

The Seventh Circuit's decision that market values should be the exclusive measure used in arriving at a fair merger exchange ration is also suspect. The court cited no authority for its conclusion; the formula it chose to use ignored case precedent on point. The Seventh Circuit also rejected testimony furnished by the parties who had consistently maintained that the examination of market value alone would not be sufficient to determine a fair exchange ratio.

Ironically, one of the cases the court ignored was its own decision, in *Lebold v. Inland S. S. Co.*[69] In *Lebold* the minority stockholders of Inland Steamship

64 *Id.* at 1247-48.

65 For an explanation of the court's merger exchange ratio formula, see 552 F.2d at 1248-49.

66 During the month following the merger, the average market value of Eltra preferred was $31.06 per share. Consequently, the Auto-Lite minority shareholders received stock worth $58.39 (1.88 x $31.06). The average market value of Eltra common for this month was $25.25 per share. Since the Mergenthaler shareholders received one share of Eltra common, the Auto-Lite shareholders received stock for each share of Auto-Lite that they held worth $58.39/$25.25 or 2.31 times as much on the market as the stock that the Mergenthaler shareholders received for each share of Mergenthaler that they held. *Id.* at 1242.

67 *Id.* at 1248-49.

68 FED. R. CIV. P. 52.

69 82 F.2d 351 (7th Cir. 1936).

filed suit to enjoin its directors and its majority stockholders, the Inland Steel Company, from taking any steps to dissolve or discontinue Inland Steamship's corporate existence or from taking any other action which would interfere with its usual operations. Inland Steel had contemplated purchasing the minority's holdings for $700 a share to avoid paying it dividends. The defendants also had threatened to dissolve Inland Steamship if the minority did not yield its stock. The Seventh Circuit, applying West Virginia law, dismissed the suits as premature since there had been no disposition of the assets, nor had the plaintiffs suffered any loss. The court stated, however, that the trial court erred in disregarding the earnings record of Inland Steamship when it concluded that $700 a share was a fair price for the minority's stock. The Seventh Circuit further stated that, "[t]he determination of [stock] value entails necessarily consideration of all elements that enter into value—cost of physical assets, additions, depreciation and appreciation, market price, earnings, the chances of future successful operation, and prospects of continued earnings. From evidence as to all such elements, true valuation is to be determined."[70]

Therefore, the Seventh Circuit in *Mills* not only ignored authorities who contend that market value by itself is not a reliable indicator of fairness, but also contradicted its decision in *Lebold*. The *Mills* court never attempted to explain or rationalize its actions.

Although the court's conclusion in *Mills* is open to criticism, its complete reliance on market values is not without support. The court's view closely parallels that of some investment analysts who espouse an economic theory of stock valuation called the "semistrong efficient market hypothesis."[71] In its extreme form this hypothesis makes two declarations: (1) that the price of most stock at nearly all times reflects whatever is knowable about the company's affairs, so that no consistent profits can be made by seeking out and using additional information, and (2) that because the market has all the information it needs to establish prices, the prices it registers are therefore correct.

The second tenet of this two-pronged theory has received considerable criticism. One such critic[72] maintains that the hypothesis does not comport with reality. He contends that persons in the market must not only have intelligence and accurate information, but must also have sound judgment and the ability to

70 *Id.* at 356. The same case reappeared for review five years later after the defendant, Inland Steel Company, had dissolved Inland Steamship in May, 1936. The Seventh Circuit concluded that the defendant's actions were unlawful since their purpose was to eradicate the minority's interest so that defendants could control the assets and business of the steamship company. In assessing damages, the Seventh Circuit decided that the value of plaintiffs' interest must be based upon the worth, not of the dissolved company's physical assets alone, but upon all of the elements mentioned in the former opinion. The court thus affirmed the principle enunciated five years earlier that all relevant factors must be considered in arriving at stock values, and, thus, at fair merger terms. Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir.), *cert. denied,* 316 U.S. 675 (1941).

71 This theory contends that markets are efficient enough that prices reflect all publicly available information. Thus, only a few insiders can (by trading on short run price changes) earn a profit which exceeds what could be earned using a "naive buy-and-hold strategy." The naive buy-and-hold strategy refers to the investment policy of randomly selecting securities, buying them and holding them over at least one complete business cycle while reinvesting all dividends. *See* FRANCIS, INVESTMENTS: ANALYSIS AND MANAGEMENT at 537-48 n.5 (1972).

72 Graham, *The Future of Common Stock,* FINANCIAL ANALYSTS JOURNAL at 20-30 (Sept.-Oct. 1974).

apply these assets well. Psychological or other extraneous factors, however, cloud investors' appraisals so that the stock prices they arrive at do not always accurately reflect the true worth of individual firms. When such factors become dominant, then correct information means little in terms of arriving at an accurate market value.[73]

Also, the experts cited by the Seventh Circuit, Brudney and Chirelstein,[74] assert that parent-subsidiary mergers, such as the one here, are not "exercises in altruism."[75] The timing of the merger and the context for seeking approval are controlled by the parent. The process of seeking stockholder endorsement is biased in favor of a vote for acceptance. The purchase price or exchange ratio is also determined unilaterally by the parent's management rather that through arm's length bargaining, so that the value placed on a subsidiary's assets will often be as low as "reasonable pessimism will allow."[76] These and other factors may depress the market price of a subsidiary like Auto-Lite so that its market value does not accurately portray its actual worth.

To assure the accuracy of the Seventh Circuit's "fairness" formula it was essential that all correct information was available to the market. In *Mills,* neither the District Court nor the Seventh Circuit ever concluded that it was. Plaintiffs maintained that the proxy materials were not totally complete regarding certain Auto-Lite subsidiaries and projected Auto-Lite earning figures. Hence, the market was not appraised of these matters. The finding that the proxy statement was misleading as a matter of law because it failed to adequately disclose the relationship between the board members of Auto-Lite and Mergenthaler demonstrates that the market and the company shareholders possibly lacked material information about the merger or at least were unable to use it in the form presented. Moreover, Brudney and Chirelstein ironically assert that a merger may be timed to reflect the parent company's anticipation of a substantial increase in the subsidiary's earnings. Because this anticipation may result from data available only to management, the information will not, in many instances, have been reflected in the market price of the subsidiary's stock.[77] Hence, any assumption by the Seventh Circuit that the market possessed all information necessary to evaluate the merger was unwarranted.

Moreover, the Seventh Circuit's reliance on market values is suspect for another reason. The court studied market prices for a six-month interval immediately preceding the merger. The market price of stock at the time of a merger, consolidation, or other corporate change, however, is generally disregarded when there have been unusual purchases of the stock prior to that time.[78] Cognizant of this fact, the district court for purposes of comparison examined the customary five-year period preceding the merger. Experts for both sides agreed that a period of five years or greater had to be examined in order to ascertain

73 *Id.* at 23.
74 Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers,* 88 HARV. L. REV. 297 (1974).
75 *Id.* at 309, n.33.
76 *Id.* at 298.
77 *Id.* at 305-6.
78 Mills v. Electric Auto-Lite Co., No. 75-1558, 75-1559, slip op. at 15 (N.D. Ill. April 11, 1975). *See also* 48 A.L.R.3d 430 (1973).

representative stock values.[79] Thus, in using a six-month formula, the Seventh Circuit rejected a factor which the district court and both parties had considered important. Moreover, the Seventh Circuit's formula, devised by the defendants and based on their reading of the Brudney and Chirelstein article,[80] used these pre-merger market values that were never validated.

B. *Attorneys' Fees*

The district court in *Mills* awarded Auto-Lite's shareholders attorneys' fees and litigation expenses. The Seventh Circuit rejected this relief based on its reading of *Alyeska Pipeline Co. v. Wilderness Society*[81] and of the earlier Supreme Court decision in *Mills*.

In *Alyeska,* the District of Columbia Circuit awarded attorneys' fees to plaintiffs who had prevailed in an action to prevent the issuance of a permit for the construction of an oil pipeline. The Supreme Court reversed the award and rejected the D.C. Circuit's "private attorney general" theory, a fee-shifting doctrine available to prevailing litigants who were deemed to have furthered the interests of a significant class of persons by bringing litigation which effectuated a strong Congressional policy. The Court held that it would be inappropriate for the judiciary, without legislative guidance, to reallocate the burdens of litigation in the manner and extent approved by the court of appeals.

Although the *Alyeska* Court refused to recognize this exception to the American Rule, which requires that litigants be responsible for payment of their respective attorneys' fees, it did acknowledge three traditional exceptions to the rule: (1) when a "common fund" is involved; (2) when the losing party has acted in bad faith, vexatiously, or for oppressive reasons; and (3) when a court order is disobeyed.

Regarding the first exception, Justice White, speaking for the majority, said that congressional action has not interfered

> with the historic power of equity to permit the trustee of a fund or property, or a party preserving or recovering a fund for the benefit of others in addition to himself, to recover his costs, including his attorneys' fees, from the fund or property itself or directly from the other parties enjoying the benefit.[82]

Alyeska must be read in light of *Mills* since in *Alyeska* the Court cited *Mills* as controlling authority for the common fund exception. The Supreme Court in *Mills* acknowledged that the "fund" exception has undergone considerable expansion since its earliest applications. According to the Court, the doctrine is applicable so long as a substantial benefit of some sort is conferred[83] on the class from which contribution is requested, even when no fund is created.[84] The

79 Brief for Defendants at 33.
80 *See* Brudney & Chirelstein, *supra* note 74 at 313-25.
81 421 U.S. 240 (1975).
82 *Id.* at 257.
83 Mills v. Electric Auto-Lite Co., 395 U.S. 375, 393 (1970).
84 "Although the earliest cases recognizing a right to reimbursement involved litigation that had produced or preserved a 'common fund' for the benefit of a group, nothing in these cases indicates that the suit must actually bring money into the court as a prerequisite to the court's power to order reimbursement of expenses." Id. at 392.

Court cited cases, such as shareholder derivative actions, in which attorneys' fees were awarded when the suits bestowed a substantial benefit on the members of an ascertainable class. In those cases, courts recognized that the expenses incurred by one shareholder in the vindication of a corporate right of action could be spread among all shareholders through an award against the corporation, regardless of whether an actual monetary recovery was obtained in the corporation's favor.

The Seventh Circuit in *Mills* reversed the lower court's award of litigation expenses, including attorneys' fees, because of its interpretation of *Alyeska* and of dicta in *Mills* that "[w]hether petitioners are successful in showing a need for significant relief may be a factor in determining whether a further award [of attorneys' fees] should be made."[85] The court of appeals understood these cases to mean that the *Mills*' plaintiffs should not recover any attorneys' fees or expenses incurred after the Supreme Court decision, but instead, should be limited to recovering all fees and expenses related to the establishment of the violation of the federal securities laws. The court of appeals did not find that plaintiffs' work on the issue of damages produced a common benefit for the former Auto-Lite minority shareholders. Nor did it find that the Securities Exchange Act provided authorization for fee shifting in this type of case or that the bad faith exception was applicable. Hence plaintiffs had to pay their own attorneys' fees and expenses for their unsuccessful attempt to obtain damages for the securities law violation.

In dealing with this issue the Seventh Circuit conceptually separated plaintiffs' suit according to its progression through the appellate system. That is, since defendants' interlocutory appeal to the Supreme Court bifurcated the judicial proceeding, the court of appeals viewed the litigation as containing two parts: one, an attempt to prove defendants' liability for the violation of § 14(a), and two, an effort to show damages because of this transgression. The court concluded that the first half of plaintiffs' suit benefited the class which plaintiffs represented as well as the corporation. Consequently, complainants could recover attorneys' fees for that segment of the litigation. Conversely, since plaintiffs failed in the second half of the litigation to benefit their class by recovering damages, they could not recoup expenses incurred in that effort.

This analysis is subject to criticism. Had both the liability and damages issues been tried contemporaneously, plaintiffs probably would have recovered all costs associated with the suit. This conclusion obtains because the court would not have separated the issues to provide that plaintiffs could recover attorneys' fees only up until the time of the trial when they attempted to prove damages. Nevertheless, the Seventh Circuit separated the issues by mistakenly conceptualizing the litigation as a two-step process instead of correctly viewing it as one continuous suit which required fourteen years to try.

Moreover, the Seventh Circuit misinterpreted the holdings of *Alyeska* and *Mills*. The court lifted dicta from the Supreme Court's decision in *Mills* which said that the plaintiffs' success in recovering money damages was a possible factor in determining whether a further award of attorneys' fees was in order. It is clear from this that plaintiffs' success was not to be the only factor, if it was to be

85 *Id.* at 396.

a factor at all. As noted, the "common fund" theory does not demand that a "fund" be created before a person can recover from members of his class; it only requires that such a person confer a substantial benefit on them. By concluding that plaintiffs in their unsuccessful attempt to recover damages conferred no benefit on their class other than "corporate therapeutics," the court overlooked the fact that these plaintiffs performed a substantial service. The Supreme Court in *Mills* remanded the case back to the district court of consideration of further relief.[86] It would have been highly unusual if, after proving liability, the plaintiffs had ceased prosecuting the matter. This was not a spurious claim; the trial court awarded plaintiffs over two million dollars for injury suffered. If plaintiffs had chosen to stop the suit, Auto-Lite or the other minority shareholders would have had to take over the case to preserve the possibility of a money award. Thus, by continuing the litigation, plaintiffs spared Auto-Lite and its minority shareholders the time and expense involved in pursuing the matter further to prove damages.

Finally, by denying attorneys' fees and expenses, the court deters minority shareholders from challenging mergers violative of the securities laws. This is contrary to the rationale for allowing private stockholders' actions. To the extent that private enforcement is deterred, the possibility of overburdening the SEC becomes more real.[87]

IV. Conclusion

The Seventh Circuit, in resolving the difficult issues with which it was faced in its second examination of *Mills v. Electric Auto-Lite Co.*, held: (1) that once determined reliable, the market value of two merging companies' stock should be the exclusive criteria in determining whether an exchange ratio is unfair, and thus, whether damages are in order; and, (2) that attorneys' fees incurrd in a fruitless attempt to recover damages for a securities law violation are not recoverable. In the process of reaching these results, the Seventh Circuit usurped the fact-finding responsibilities of the district court, contradicted its own decision in *Lebold v. Inland S. S. Co.*, ignored expert testimony presented in the case at bar, and misinterpreted decisions regarding attorneys' fees rendered by the Supreme Court.

The court's selection of the single-factor damages formula is the most troublesome aspect of its decision. It becomes more understandable, however, in light of the vast complexities involved in determining damages under a theory so vague as the "fairness" theory. It is likely that the court retreated to its

86 *Id.* at 389.

87 Although plaintiffs chose not to ask for punitive damages, this form of relief deserves note. Federal courts have held that punitive damages are not available under implied remedies, such as the one invoked here. *See* de Haas v. Empire Petroleum Co., 435 F.2d 1223 (10th Cir. 1970); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), *cert. denied,* 395 U.S. 977 (1969). One of the reasons for not allowing such an award is that sufficient incentive for private suits is provided in the form of class actions and stockholder derivative suits, both of which allow recovery of costs, including attorneys' fees. Under the Seventh Circuit's rationale, plaintiffs could be put in a vicious circle; they would not be awarded attorneys' fees, and they would not be given punitive damages because they usually receive the former. *See,* Note, *Section 28(a) of the Securities Exchange Act: Punitive Damages and Pendent State Claims,* 46 U. COLO. L. REV. 59, 63-64 (1974).

relatively elementary market value approach as a means of organizing and simplifying the morass of information presented by the parties to establish the merger's fairness or unfairness.

The Seventh Circuit's desire was clearly to make the case more manageable, since the matter had been in the process of litigation for nearly 14 years and had produced a morass of legal paperwork. Some simplification is desirable because it allows the court to deal more easily with intricate merger cases and to reduce the time and expense incurred by litigants. Oversimplification, however, is to be avoided; it threatens the equitable resolution of merger suits. In some instances, fairness requires a detailed analysis which accounts for a case's distinctive features.

Considering the extremely complex problems *Mills* presented, it appears that the Seventh Circuit took a simplistic rather than a merely simplified approach. Whether the Seventh Circuit's analysis resulted from an impatience with the incredibily lengthy and complicated nature of *Mills,* or sprang from a bona fide belief in the reliability of market values and a good faith desire to simplify the determination of damages, the result of this case—that after proving a securities law violation and pursuing the matter for some fourteen years, plaintiffs are left with nothing[88]—shocks one's sense of equity and signals future litigants to be on guard against similar judicial shortcuts that may result in injustices.

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88 The possibility of this result was predicted seven years ago immediately after the Supreme Court's decision in *Mills. See* note 29 *supra.*

SECURITIES REGULATION—RECKLESSNESS SUFFICIENT FOR LIABILITY IN A PRIVATE RULE 10b-5 ACTION.

*Sundstrand Corp. v. Sun Chemical Corp.**

I. Introduction

In *Sundstrand Corp. v. Sun Chemical Corp.*, the Seventh Circuit faced the question whether it would extend the Supreme Court's holding in *Ernst & Ernst v. Hochfelder*[1] by finding recklessness sufficient to support a private cause of action under § 10(b) of the Securities Exchange Act of 1934[2] and SEC rule 10b-5.[3] The Seventh Circuit relied on both its prior decision in *Bailey v. Meister Brau, Inc.*,[4] and the common law to conclude that recklessness is within the ambit of *scienter*, as defined by the Supreme Court in *Hochfelder*, and thus sufficient to create liability in a private action under rule 10b-5.

II. Statement of the Case

As the Seventh Circuit acknowledged, the facts of the litigation are complex.[5] The cause of action arose out of a stock option transfer[6] that occurred while Sundstrand was engaged in merger negotiations with Standard Kollsman Industries (SKI).[7] The controversy centered around three men: John B. Huarisa,[8] president and a major shareholder of SKI; James Ethington, president of Sundstrand; and Henry W. Meers, a partner in the investment banking firm of White, Weld & Co., and an outside director of SKI. Meers acted as the merger broker, and his firm was to be paid a fee of $150,000 for the investment banking services to be performed in connection with the merger, if consummated.

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* 553 F.2d 1033 (7th Cir.), *cert. denied*, 46 U.S.L.W. 3219 (U.S. Oct. 4, 1977).

1 425 U.S. 185 (1976), *rev'g.* 503 F.2d 1110 (7th Cir. 1974).

2 This section provides in part:

> It shall be unlawful for any person directly or indirectly . . . to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange . . . any manipulative or deceptive device or contrivance in contravention of such rule and regulations as the Commission may prescribe in the public interest or for the protection of investors.

Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970).

3 Rule 10b-5 states, in part:

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

16 C.F.R. § 240.10b-5 (1976).

4 535 F.2d 982 (7th Cir. 1976).

5 553 F.2d at 1037.

6 A stock option is a contractual right to buy a certain number of shares at a predetermined price within a specified time.

7 In 1972 SKI merged into Sun Chemical; thus, Sun Chemical was named as a defendant. 553 F.2d at 1036 n.1.

8 Huarisa died during the course of the litigation and his coexecutors were substituted as defendants.

A. *The Merger Negotiations*

In early 1968, Ethington told Meers of Sundstrand's interest in acquiring other companies. In September of that year, Meers was informed that Sundstrand had a particular interest in acquiring SKI. In mid-November, 1968, Huarisa directed Meers to contact Ethington. Merger negotiations began and continued through December.

In late December, Sundstrand made an offer to acquire SKI. Huarisa rejected the offer as too low and arranged a meeting between Meers and Ethington to negotiate another price. On December 26, Ethington made an offer that Meers, as agent for SKI, accepted after consulting with Huarisa. The SKI board of directors ratified this proposal on January 2, 1969. Five days later, officers and employees of Sundstrand began a study of SKI to ascertain the desirability of completing the merger. Sundstrand, on January 20, cancelled the merger negotiations.[9]

B. *The Contest With Sun Chemical*

During the merger negotiations, Sun Chemical offered to purchase one quarter million shares of SKI common stock held by the Burke family[10] and upon which Huarisa had a first refusal right.[11] This offer, made on December 10, 1968, triggered Huarisa's right of first refusal over the Burke stock and gave him thirty days within which to buy the stock. Huarisa planned to purchase the stock and then sell it at a higher price to Sundstrand under the provisions of the proposed merger. Huarisa, however, learned from his lawyers early in January, 1969, that this transaction would have tax and securities law problems.

Sun Chemical wished to acquire the Burke shares to use their voting power to thwart Sundstrand's merger with SKI. Sundstrand therefore had to block that purchase if it hoped to complete the planned merger. Thus, Sundstrand arranged a meeting for January 6 to devise a method of transferring this stock through Huarisa without adverse legal effects.[12] At the meeting it was agreed that Huarisa would exercise his first refusal right by paying a small percentage of the total purchase price for the quarter million shares. Huarisa would transfer his option to Sundstrand in exchange for shares of Sundstrand's common stock. Sundstrand would then own the option and have the remaining period of time within which to pay the balance of the purchase price. On January 9, the written transfer agreement was executed by Sundstrand and Huarisa. Meers was not present on either occasion.

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9 The district court found the following reasons for the cancellation of the merger negotiations:

> Certain aspects of the SKI operation, including an increase in labor costs which a merger would cause, undesirable SKI labor practices, and lack of expected compatibility of SKI's and Sundstrand's products, made the acquisition unattractive. The opinion was also expressed that SKI's earnings projects were somewhat optimistic [due in large part to SKI's heavy deferral preproduction costs].

553 F.2d at 1038.

10 Burke was the deceased founder of SKI.

11 A first refusal right is a contractual right which gives its holder the opportunity to purchase shares of stock at a predetermined price, when another has offered to buy the shares.

12 As the Seventh Circuit stated, "Sundstrand wanted to keep the matter as secret as possible from Sun Chemical and the Burke family." 553 F.2d at 1049 n.33.

Sundstrand's competition with Sun Chemical for control of SKI explains the fast pace at which this multimillion dollar option transfer took place. As the Seventh Circuit noted: "A prerequisite of the merger, *viz.*, keeping the huge block of Burke stock out of Sun Chemical's hands, prompted Sundstrand to execute the agreement."[13]

On January 22, two days after cancelling the merger negotiations, Sundstrand announced its decision to go through with the purchase of the block of shares.[14] Sundstrand purchased the shares from an escrowee bank on February 6 and began looking for a purchaser for these shares four days later.

C. *The Accounting Reports*

On March 21, 1969, Ethington learned of the existence of accounting reports that questioned, as early as May, 1968, certain accounting practices[15] that overstated SKI's 1968 earnings.[16] These reports had not been disclosed to Sundstrand by either Huarisa or Meers prior to the execution of the stock option transfer agreement.

In May, 1968, James W. Burke,[17] a director of SKI, began to question SKI's board of directors about the practice of continued deferral of preproduction costs. The practice had been noted in the financial statements of SKI's 1967 annual report. The following month, Burke submitted a letter on the practice written by an accountant from Ernst & Ernst, whom Burke had retained. The letter questioned the propriety of the accounting practice. The letter, however, was not a formal opinion, as the study had not been done in conformity with generally accepted auditing procedures.

The SKI board of directors considered the reports at twenty-five meetings. SKI's accountant, Price Waterhouse, prepared responses to Burke's questions. The result of this action was a decision by the board that the company's accounting procedures were proper and Burke's criticisms without merit. Burke, dissatisfied with the response he received from the board, took his complaint to the Securities Exchange Commission (SEC). A meeting was held at the SEC's Washington, D. C., office. In attendance were a SKI attorney and a member of Price Waterhouse. It was determined at the meeting that the 1967 annual report was not based on improper accounting practices. Price Waterhouse assured the SEC that it would re-evaluate the use of the accounting procedure in question when it prepared the 1968 annual report.

On January 27, 1969, more than two weeks after the stock option transfer took place, Price Waterhouse issued a memorandum that indicated that large write-offs would have to be made in the 1968 financial statements.

13 *Id.* at 1049.

14 The Seventh Circuit discovered from its own study of the record that Sundstrand was not obligated to pursue this course of action, since the option Sundstrand held was not a duty to buy the shares but a right to buy them. Sundstrand's counsel incorrectly advised management of its obligations under the option.

15 SKI had been carrying the preproduction costs on a large computer project as assets to be amortized over future government contracts, instead of charging the costs as expenses when incurred.

16 The 1968 earnings projection had been about $2.00 per share. The 1968 annual report showed a 15 cent per share loss.

17 James W. Burke was a son of the founder of SKI. When the founder died, Huarisa was brought in as president. Huarisa later demoted Burke for incompetence.

D. *The Litigation*

After an unsuccessful attempt to rescind the stock option transfer agreement, Sundstrand brought this action against SKI, Huarisa and Meers. Sundstrand alleged that all had violated § 10(b) of the Securities Exchange Act of 1934[18] and SEC rule 10b-5[19] by misrepresenting and omitting material facts about the financial condition of SKI during the merger talks. Sundstrand maintained that it relied on the misrepresentations and omissions in the stock option transfer with Huarisa.

The United States District Court for the Northern District of Illinois held that SKI and Huarisa had intentionally or recklessly misrepresented material facts concerning SKI's financial condition.[20] The district court found Meers liable for negligent failure to disclose the Burke report and Ernst & Ernst letter.

The Seventh Circuit affirmed the district court's finding of liability for SKI and Huarisa. Since the lower court acted prior to *Hochfelder,* there had been no finding that Meers acted with *scienter,* the standard mandated by *Hochfelder* for liability in private rule 10b-5 actions. Rather than remand the case to the district court, however, the Seventh Circuit found, as a matter of law, that Meers's conduct constituted "reckless nondisclosure" and thus met the *scienter* requirement of *Hochfelder.*[21]

Rule 10b-5, issued by the Securities and Exchange Commission under the authority of § 10(b) of the Securities Exchange Act, is the premier remedy for securities fraud. Congress intended § 10(b) to insure fair and complete disclosure in securities dealings and to prevent manipulation in securities markets. Rule 10b-5 was issued by the SEC in furtherance of those Congressional policies.

Rule 10b-5 encompasses the "purchase and sale of any security," whether in an organized exchange or a private transaction as in *Sundstrand.* Civil liability extends to "any person directly or indirectly" connected with a purchase or sale. Any purchaser or seller of securities can maintain a cause of action under rule 10b-5 if five elements are alleged. Federal jurisdiction must first be invoked. This element is satisfied by the use of the mails or some other instrumentality of interstate commerce. Second, the plaintiff must allege a manipulative or deceptive device or contrivance. Third, the act or omission must be material, as that term is used at common law. If materiality is shown, reliance is assumed and need not be proven. Fourth, the plaintiff must allege that the defendant acted with *scienter. Scienter,* a term of art at common law, is a prescribed mental state that the defendant must have during the commission of the wrongful act.

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18 U.S.C. § 78j(b) (1970). *See* note 2 *supra.*

19 17 C.F.R. § 240.10b-5 (1976). *See* note 3 *supra.*

20 Specifically, the district court found that Huarisa:

> [d]eliberately, or, at least, recklessly, misrepresented SKI's nine months' earnings, SKI's earnings for 1968 and for 1969, the interest of other companies in acquiring SKI at a price of $45 and the amount of potential write-offs of deferred preproduction costs for 1968. Huarisa also deliberately, or recklessly, failed to disclose the existence of the Burke and Ernst & Ernst reports, the Price Waterhouse memorandum of January 27, 1969, and the need for write-offs because of losses on contracts at year-end 1968.

553 F.2d at 1039.

21 *Id.* at 1044.

Finally, the plaintiff must allege that he suffered damages as a result of the defendant's unlawful behavior.

This comment will deal primarily with the fourth element, *scienter.* The comment will first analyze the Seventh Circuit's development of a new *scienter* standard for rule 10b-5 liability. The comment will consider the Supreme Court's holding in *Hochfelder,* the Seventh Circuit's reliance on its prior opinion in *Meister Brau,* and the *scienter* standard for fraud and deceit at common law. Second, this comment will examine the Seventh Circuit's application of its newly articulated standard to the facts in *Sundstrand.*

III. The Seventh Circuit's Search for a New Standard

A. *The Unanswered Question in* Hochfelder

Prior to the Supreme Court's opinion in *Ernst & Ernst v. Hochfelder,*[22] the circuits were split on the standard of conduct necessary to maintain a private cause of action under rule 10b-5. The *Hochfelder* Court held specifically that "*scienter*—intent to deceive, manipulate, or defraud" must be alleged for a private 10b-5 action.[23] This holding did not lay to rest the issue of *scienter,* however, as the Supreme Court did not answer the question whether recklessness might be sufficient to satisfy the requirement. A footnote in *Hochfelder* reserved this question:

> In this opinion the term "scienter" refers to a mental state embracing intent to deceive, manipulate, or defraud. In certain areas of the law *recklessness is considered to be a form of intentional conduct* for purposes of imposing liability for some act. We need not address here the question *whether, in some circumstances, reckless behavior is sufficient* for civil liability under § 10(b) and Rule 10b-5.[24]

The *Hochfelder* Court did not explicitly rely on or mention the common law in defining the *scienter* requirement.[25] Nevertheless, the legislative intent behind § 10(b), upon which the Supreme Court explicitly relied, contains references to the common law.

The Supreme Court prefaced its discussion of the legislative history of the Securities Exchange Act of 1934 by stating:

> . . . [W]e think the relevant portions of that history support our conclusion that § 10(b) was addressed to *practices that involve some element of scienter* and cannot be read to impose liability for *negligent conduct alone.*[26]

22 In *Hochfelder,* investors of a bankrupt stock brokerage firm sued the firm's accountant for failure to discover the fraudulent practices of the firm's president. The Supreme Court reversed the Seventh Circuit's use of a negligence standard to assess liability in this private 10b-5 action.

23 425 U.S. at 193.

24 *Id.* at n.12 (emphasis added).

25 The Supreme Court supported its decision on three bases: a "plain meaning" reading of § 10(b), a comparison of § 10(b) with the procedural and substantive requirements of the other provisions of the Act, and the legislative history of § 10(b).

26 425 U.S. at 201 (emphasis added).

The Court's choice of words here further explains its meaning of *scienter*. Only "some element" of the scienter requirement is necessary, and although negligence specifically is excluded, the Court did not mention recklessness.

The Supreme Court cited the Senate Report on the 1934 Act, which commented on the express civil causes of action provided in the legislation:

> . . . The bill provides that any person who unlawfully manipulates the price of a security, or who induces transactions in a security by means of false or misleading statements, or who makes a false or misleading statement in the report of a corporation, shall be liable in damages to those who have bought or sold the security at prices affected by such violation or statement. In such case the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, and that he relied thereon to his damage. The defendant may escape liability by showing the statement was made in *good faith.*[27]

The requirement that one can only be liable when he acted in other than good faith is met by a recklessness standard. Although a defense of good faith vitiates liability in negligence, recklessness is never defeated by a showing of good faith.[28]

Additionally, the Supreme Court cited[29] Chief Judge Cardozo's policy analysis in the landmark case of *Ultramares Corp. v. Touche.*[30] Cardozo held that a cause of action by third party investors against an accountant could not sound in negligence, but warned that an accountant could be liable in fraud. Fraud at that time included a recklessness standard.[31]

The evidence strongly suggests that the Supreme Court ultimately based its opinion in *Hochfelder* on the common law. The Court's citations to both the Senate Report that mentions the common law and the leading common law case, as well as its use of the common law term of art *scienter,* lead to this conclusion. Since the origins of the *Hochfelder* doctrine lay in the common law, an analysis of the common law requirements for *scienter* will help to determine if the standard of recklessness, as outlined by the Seventh Circuit, is consistent with the Supreme Court's holding.

B. *The Answer in* Sundstrand

The Seventh Circuit in *Sundstrand* did not fully analyze the relation between the *Hochfelder scienter* requirement in a rule 10b-5 action and the common law *scienter* requirement in a cause of action for fraud or deceit. Instead, the *Sundstrand* court stated that the question whether recklessness was sufficient for a 10b-5 action had been decided in its *Bailey v. Meister Brau, Inc.,*[32] opinion.

27 425 U.S. at 206 (emphasis added).
28 McLean v. Alexander, 420 F. Supp. 1057, 1081 (D. Del. 1976).
29 425 U.S. at 214-15 n.33.
30 255 N.Y. 170, 174 N.E. 441 (1931).
31 *See* text accompanying notes 43-47 *infra.*
32 535 F.2d 982, 993 (7th Cir. 1976). The court in *Sunstrand* said: *"Bailey v. Meister Brau, Inc.,* [citation omitted] resolved for this Circuit the ambiguity in footnote 12 of *Hochfelder* in favor of including reckless behavior in the definition of what behavior is necessary to maintain a rule 10b-5 action." 553 F.2d at 1044.

Meister Brau is not definitive, however, and its 10b-5 holding was, at best, unnecessary.[33]

Meister Brau involved an executor's disposal of a majority of shares in a close corporation that had been owned by the company's founder. Bailey, a minority stockholder, had a right of first refusal on the founder's shares. The executor, in derogation of Bailey's first refusal right, exchanged the shares for unregistered shares of Meister Brau. The value of the Meister Brau shares was much less than the assets transferred in the stock exchange. Bailey brought an action against the executor and Meister Brau based on two counts: in his own behalf for intentional interference with his contractual right of first refusal and on behalf of the company in a derivative claim for violations of rule 10b-5. The Seventh Circuit affirmed liability on both counts.

Damages were awarded Bailey solely on the intentional tort; no damages were awarded on the 10b-5 claim. The Seventh Circuit explained that any award of damages under the 10b-5 claim would unjustly enrich Meister Brau as present owner of the company. Moreover, the court held that damages would be duplicative for Bailey as he had already received his pro rata share of the damage to the company under the intentional tort.

The 10b-5 action had been brought to recover damages. Once the district court realized that no damages could be awarded for a violation of 10b-5, any further discussion of this count had become dictum. Nevertheless, the district court rationalized its holding on 10b-5 as a necessary basis for an award of attorney's fees to the plaintiff. On appeal, however, the Seventh Circuit held the award of attorney's fees was error. The Seventh Circuit thus eliminated whatever justification there had been for deciding the 10b-5 issue.

Even if some precedential value in the *Meister Brau* holding on 10b-5 is assumed, the Seventh Circuit's discussion of 10b-5 liability in that case is loosely reasoned and poor authority to cite or consider as an extension of the *Hochfelder* doctrine. The Seventh Circuit affirmed liability as found by the district court. The district court, which acted over a year before *Hochfelder,* found that the executor in *Meister Brau*

> . . . [was] *grossly negligent* in failing to recognize the unfairness of the asset transfer . . . [and] blinded by conflict of interest wantonly ignore[d] evidence of the unfairness of [the] securities transaction to the corporation and therefore fail[ed] to disclose this evidence to those stockholders whose interests lie with the corporation.[34]

Gross negligence, however, the standard that the Seventh Circuit approved, is precluded by the *Hochfelder scienter* requirement: "intent to deceive, manipulate or defraud."[35] This gross negligence standard does not even meet the suggestion

33 *Meister Brau* was argued a year before the *Hochfelder* decision. Obviously plaintiff's counsel had relied on the existing Seventh Circuit holding that negligence was sufficient for civil liability under rule 10b-5. *See, e.g.,* Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963).

The opinion in *Meister Brau,* handed down a few weeks after the *Hochfelder* decision, states in a footnote: "There is nothing to the contrary in Ernst & Ernst v. Hochfelder [citations omitted]." 535 F.2d at 994 n.14. This, however, appears to have been a mere afterthought; the opinion contains no analysis of the Seventh Circuit's extension of *Hochfelder.*

34 535 F.2d at 993 (emphasis added).

35 425 U.S. at 193.

of the Supreme Court that recklessness might be considered a form of intentional conduct for purposes of imposing liability.[36] The *Meister Brau* standard is nothing more than "inexcusable negligence," a standard the *Hochfelder* Court specifically held insufficient to sustain 10b-5 actions.[37] Thus, if there is precedent for *Sundstrand,* it is certainly not *Meister Brau.*

The Seventh Circuit in *Sundstrand* also cited[38] the District Court of Delaware opinion in *McLean v. Alexander*[39] as supportive of its recklessness holding. *McLean* drew its precedent from the common law; it looked at the 10b-5 *scienter* requirement in light of the common law *scienter* standard that existed at the time of the passage of the Securities Exchange Act of 1934. The *McLean* litigation involved an investor who relied on an accountant's materially false opinion audit in purchasing all the stock of a corporation. The investor sued the accountant on two theories: a violation of rule 10b-5 and the common law tort of fraud. The district court found the accountant liable under both theories.

The *McLean* court noted that although the accountant's conduct constituted far more than mere negligence, it fell short of a preconceived actual intent to defraud. The court faced the question whether the accountant's behavior, which embraced both actual knowledge of material facts not revealed and reckless disregard of the truth, met the *scienter* requirement of *Hochfelder.* After stating that *Hochfelder* was not dispositive of the issue before it, the district court continued:

> . . . *Hochfelder* does serve as a starting point for analysis. It defined "scienter" as the "mental state embracing intent to deceive, manipulate, or defraud." Further, it stated "that § 10(b) was intended to proscribe knowing or intentional conduct." It necessarily follows that scienter for purposes of imposition of civil liability under Section 10(b) and Rule 10b-5 encompasses knowing or intentional misconduct. If the result were otherwise, Section 10(b) and Rule 10b-5 would be more restrictive in substantive scope than the substantial law of fraud. Reckless disregard for the truth is also a cognizable basis for liability in common-law fraud actions. There is no hint in *Hochfelder* that the Court intended a radical departure from accepted principles.[40]

To support its reasoning, the district court developed the important connection between the *Hochfelder* Court's interpretation of the congressional intent behind § 10(b) and the common law defense of good faith. The *Hochfelder* Court interpreted the congressional intent to prohibit liability unless one acted in other than good faith. The common law holds that the defense of good faith is appropriate only in negligence actions. The Delaware district court concluded: "Congress intended 10(b) to govern reckless, knowing or deliberate conduct, none of which are negatived by a defense of good faith."[41]

The Seventh Circuit agreed with the district court's analysis, stating:

36 *Id.* at 193-94 n.12.
37 *Id.* at 190 n.5.
38 553 F.2d at 1044.
39 420 F. Supp. 1057 (D. Del. 1976).
40 *Id.* at 1081 (emphasis added) (footnotes omitted).
41 *Id.* (footnotes omitted). *See* text accompanying notes 27-28 *supra.*

> At common law reckless behavior was sufficient to support causes of action sounding in fraud or deceit. Since there is no hint in *Hochfelder* that the Court intended a radical departure from accepted rule 10b-5 principles, it would be highly inappropriate to construe the rule 10b-5 remedy to be more restrictive in substantive scope than its common law analogs.[42]

Since both courts looked to the common law for the answer to the *Hochfelder* question, it is necessary to examine the *scienter* standard for common law fraud at the time of the congressional passage of the 1934 Act. This examination is critical due to the Supreme Court's reliance in *Hochfelder* on the legislative intent of the 1934 Act.

C. *The Common Law Analogs*

A line of authoritative cases demonstrates that recklessness is clearly within the ambit of the *scienter* requirement in common law fraud actions.

The classic English case of *Derry v. Peek*[43] begins the lineage of modern day common law fraud cases. In that case, the House of Lords held that there could be no liability for negligent misrepresentations in a prospectus that resulted in losses to third party investors. The House of Lords held that for a third party investor not in privity to maintain a cause of action, the misrepresentations must be fraudulent. The opinion articulated the elements for the action of deceit, which included recklessness:

> First, in order to sustain an action of deceit, there must be proof of fraud, and nothing short of that will suffice. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. Although I have treated the second and third as distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states. . . . Thirdly, if fraud be proved, the motive of the person guilty is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made.[44]

The English doctrine was quickly assimilated in America. It received express approval, for example, in Cardozo's opinion in *Ultramares Corp. v. Touche*.[45] Similarly, the Second Circuit in *O'Connor v. Ludlam*[46] relied on the *Derry* doctrine outlined a half century before. The *O'Connor* case also involved the standard of liability necessary for a third party not in privity to sustain an action against an accountant. The Second Circuit reiterated the *Derry* criteria for liability and held: "Fraud may be established by showing a false representation had been made knowingly or without belief in its truth, or in reckless disregard of whether it be true or false."[47]

The cases demonstrate that both before and after the passage of the Secur-

42 553 F.2d at 1044.
43 [1889] 14 App. Cas. 337.
44 *Id.* at 374. The Supreme Court in *Hochfelder* reaffirmed the third element in the rule. *See* text accompanying notes 27-28 *supra.*
45 *See* text accompanying notes 29-31 *supra.*
46 92 F.2d 50 (2d Cir. 1937).
47 *Id.* at 54-55.

ities Exchange Act of 1934, the common law held an actor liable for reckless misrepresentations or omissions of material information which a third party not in privity relied upon to his detriment. Congress passed the 1934 Act to increase the protection and remedies available to investors. It is illogical to argue that Congress intended to set a stricter standard for liability than was already available at that time at common law.

D. *The Standard of Recklessness Defined*

The Seventh Circuit did not attempt to define the term recklessness in the context of affirmative misrepresentation. It can be assumed that the Seventh Circuit intended the term to be used in its usual common law sense.[48]

However, the court developed a more extensive analysis of the reckless behavior standard in the context of nondisclosure, since Meers was held liable for substantial damages for conduct that comprised solely a reckless omission. The Seventh Circuit drew on a definition of reckless omission formulated in *Franke v. Midwestern Oklahoma Development Authority*:[49]

> Reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendants or is so obvious that the actor must have been aware of it.

The *Sundstrand* court concluded that the *Franke* definition of recklessness, although not conceptually equivalent to intent, serves as a proper legally functional equivalent of intent.[50] The Seventh Circuit's caution in extending *Hoch-*

48 Dean Prosser was unique in his ability to explain complex legal doctrines in easily understood language. His articulation of a definition for recklessness is helpful here:

> The usual meaning assigned to . . . "reckless" . . . is that the actor has intentionally done an act of an unreasonable character in disregard of a risk known to him or so obvious that he must have been aware of it, and so great as to make it highly probable that harm would follow. It usually is accompanied by a conscious indifference to the consequences, amounting almost to a willingness that they shall follow; and it has been said that this is indispensable. Since, however, it is almost never admitted, and can be proved only by the conduct and the circumstances, an objective standard must of necessity in practice be applied. This requirement therefore breaks down, and receives at best lip service, in any case where it is clear from the facts that the defendant, whatever his state of mind, has proceeded in disregard of a high degree of danger, either known to him or apparent to a reasonable man in his position. The result is that . . . "reckless" conduct tends to take on the aspect of highly unreasonable conduct, or an extreme departure from ordinary care, in a situation where a high degree of danger is apparent.

W. PROSSER, THE LAW OF TORTS, § 34 at 185 (4th ed. 1971) [hereinafter cited as PROSSER].

49 428 F. Supp. 719, 725 (O.D. Okl. 1976). In this case, there was no evidence of reckless omissions by the defendants. The defendants were counsel who had been retained by the state agency in connection with a tax exempt bond offering.

50 The Seventh Circuit's reasoning recalls the *Hochfelder* Court's statement: "In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." 425 U.S. at 193-94 n.12.

The Seventh Circuit stressed the severity of this standard in a later case. After citing and discussing *Sundstrand,* the court wrote:

> In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the definition of "reckless behavior" should not be a liberal one lest any discernible distinction between "scienter" and "negligence" be obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind.

felder is evident here; the common law finds liability for fraud and deceit in reckless conduct. In stating that recklessness is the functional equivalent of intent, the Seventh Circuit merely asserted the truism that the difference between intent and recklessness in fraud or deceit is so fine that the courts have had no difficulty in holding *scienter* to include both intent and recklessness.[51]

The *Sundstrand* court explained that the *Franke* definition of recklessness combines both objective and subjective examinations of the actor's nondisclosure. The objective test must show that the danger of misleading was so apparent that the law will hold a reasonable person legally bound to know it.[52] The subjective test must show that the nondisclosure resulted "from something more egregious than even 'white heart/empty head' good faith."[53] The court suggested that the subjective test would not be met if, for example, the defendant genuinely forgot to make the disclosure or it never came to his mind.[54]

The subjective inquiry, however, is unnecessary and to a great extent misleading. Once it is objectively shown that the omission includes an extreme and highly unreasonable departure from the standards of ordinary care and presents a high degree of danger to the buyer, good faith becomes irrelevant. Recklessness by definition precludes good faith. Whenever recklessness is shown, the law no longer considers whether the actor proceeded in other than good faith.[55]

The Seventh Circuit was concerned that an actor might be liable despite his forgetfulness. The objective test, however, addresses that concern. If it is proven that an actor forgot to make a disclosure or that it never came to his mind, knowledge of circumstances creating the high risk of danger has not been proven and the objective test has not been met.

The *Sundstrand* court more fully developed the standard by which rule 10b-5 liability is assessed. In holding recklessness to be within the *Hochfelder* definition of *scienter,* the Seventh Circuit has provided federal courts with needed assistance, in the absence of more explicit guidance by the Supreme Court. Yet the Seventh Circuit's use of *Meister Brau,* its deferral to the common law without fuller development, and its unnecessary and confusing discussion of an implied subjective test in the *Franke* standard reduce the precedential value that the *Sundstrand* opinion would otherwise have.

IV. The Court's Treatment of Meers

A. *The Court's Characterization of Meers as a Quasi-Fiduciary*

The common law holds that when parties deal at arm's length, there is no

Sanders v. John Nuveen & Co., 554 F.2d 790, 793 (7th Cir. 1977).

This opinion further weakens the precedential value of *Meister Brau,* which articulated liability in terms of gross negligence. *See* text accompanying notes 33-38 *supra.*

51 Prosser maintains that the distinction between intent and negligence is conceptually justifiable. Reckless conduct involves an actor's *appreciation of a great risk of danger,* whereas intent requires an actor's *knowledge that the consequences of his actions are substantially certain to follow from what he does.* The line between intent and recklessness has been drawn by the courts at the point where the known danger ceases to be a foreseeable risk and becomes a substantial certainty. PROSSER § 8 at 32.

52 553 F.2d at 1015.

53 *Id.*

54 *Id.* at n.20.

55 *See* text accompanying notes 27-28 *supra.*

duty to disclose material facts. The common law requires a fiduciary relationship[56] between the parties to create a positive duty on the part of the fiduciary to disclose material facts.[57] A cursory examination of Meers's relationship leads to the conclusion that he was under no fiduciary duty to disclose material facts to Sundstrand. Meers was an outside director of SKI, and he acted as agent for Huarisa at the bargaining session on December 26, 1968. Yet a closer evaluation of Meers's prior dealings with Sundstrand and his functions as a corporate merger broker led the court to conclude that Meers had a duty to disclose material information to Sundstrand in their "direct-personal transaction."[58]

Courts have been willing to look beyond the strictly defined fiduciary relationship into the nature of the dealings between the parties and their past associations. The Restatement of Torts states that a "party to a business transaction is under a duty to exercise reasonable care to disclose . . . such matters as the other is entitled to know because of a fiduciary *or other similar relation of trust and confidence between them.*"[59] Prosser's research discovered:

> . . . A rather amorphous tendency on the part of most courts to find a duty of disclosure in cases where the defendant has special knowledge, or means of knowledge, not open to the plaintiff, and is aware that the plaintiff is acting under a misrepresentation as to the facts which could be of importance to him, and would probably affect his decision.[60]

The Seventh Circuit reported that Meers's investment banking firm had previously acted as co-managing underwriter of a Sundstrand public offering. Meers was personally involved in this work, and a firm partner who worked under Meers on the underwriting continued to make regular business calls on their client, Sundstrand, until the existence of the accounting reports was made known to Sundstrand in March, 1969.[61] This past and continuing association led the Seventh Circuit to conclude that Meers was a "quasi-fiduciary"[62] to Sundstrand in their banker-client relationship, even though "officially" Meers represented SKI and Huarisa in the merger negotiations. As the trial court fittingly observed, "[Meers was] on both sides and in the middle of the transaction."[63]

By classifying Meers as a "quasi-fiduciary" to Sundstrand, the Seventh Circuit could hold him to a duty to disclose material information. In so doing,

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56 A fiduciary relationship is one of trust and confidence. The fiduciary acts for the benefit and protection of the beneficiary. Examples of such a relationship are: principal and agent, executor and beneficiary of an estate, bank and investing depositor, majority and minority stockholders, guardian and ward, attorney and client, and numerous other relationships that involve special trust and confidence. PROSSER § 106 at 697.

57 *See* Carr v. New York Stock Exchange, 414 F. Supp. 1292 at 1299-1300 (N.D. Calif. 1976); Haimoff, *Holmes Looks at Hochfelder and 10b-5,* 32 BUS. LAW. 147 at 164-73.

58 Bromberg in his treatise on rule 10b-5 has categorized various types of dealings that take place in the securities industry. The direct-personal transaction demands the highest standard of care. 2 BROMBERG, SECURITIES LAW FRAUD, § 6 (1977).

59 RESTATEMENT OF TORTS, § 551 (1938) (emphasis added).

60 PROSSER, § 106 at 697.

61 553 F.2d at 1043, n.12.

62 Presumedly, the Seventh Circuit used the term "quasi-fiduciary" because Meers did not fit precisely within the typical classifications of a fiduciary. *See* note 56 *supra.*

63 553 F.2d at 1043.

the court applied established common law principles.[64]

B. *The Application of the Standard*

The district court, which acted prior to the *Hochfelder* decision, made no finding of fact that Meers's non-disclosure of the accounting reports to Sundstrand was reckless; it imposed liability on a negligence standard that *Hochfelder* specifically invalidated. Rather than remand the case to the district court for further consideration of Meers's conduct, the Seventh Circuit found Meers reckless as a matter of law, based on the facts as delineated by the district court.

Meers denied actual knowledge of the danger of misleading Sundstrand by not disclosing the existence of the accounting reports. The district court made no finding that Meers had such knowledge. The Seventh Circuit held, however, that the district court's finding on the objective obviousness of the danger was sufficient for liability under the objective element of the *Franke* test. The Seventh Circuit argued that the degree of danger that threatened Sunstrand by the non-disclosure was so great that a reasonable person must have known of the danger.

The Seventh Circuit continued its application of the *Franke* test and concluded that Meers's conduct met the subjective test. The court wanted to avoid holding Meers liable if he had genuinely forgotten to make the disclosure.[65] The court reasoned that forgetfulness proves good faith, which would vitiate liability. This reasoning, however, is deficient in two respects.

First, it should be noted that good faith is not a defense to reckless or intentional conduct. Second, an actor who proves that he genuinely forgot to make the disclosure also proves that he did not have an awareness of the circumstances that created the high risk of danger. A knowledge of circumstances creating the high risk of danger must be proven in order to hold the actor liable on the objective test. Although the Seventh Circuit's discussion of a subjective element was unnecessary and confusing, the court held that the facts before it showed that Meers did not forget to make the disclosure; rather, the court found that the record demonstrated that Meers consciously decided to withhold the substance of the reports from Sundstrand.[66]

Since both elements of the *Franke* test were met, the Seventh Circuit concluded that recklessness had been established as a matter of law, based on the findings of the lower court. This holding is suspect for two reasons. The Seventh Circuit held Meers reckless as a matter of law, which is equivalent to saying that reasonable persons could not disagree with the result. Yet reasonable persons

64 In a more expansive view of rule 10b-5, the SEC has argued that the common law principles of a fiduciary relationship have no application in a 10b-5 action. *See* Cady, Roberts & Co., 40 S.E.C. 907, 913-14 (1961). In light of the restrictive approach taken by the Supreme Court in *Hochfelder,* however, it is doubtful that such an expansion would be upheld. By finding that Meers had a duty to disclose as a "quasi-fiduciary," the Seventh Circuit again demonstrated its caution in expanding liability in light of *Hochfelder.* For other examples of the Seventh Circuit's caution, *see* text accompanying notes 50-51 *supra.*

65 *See* text accompanying notes 53-55 *supra.*

66 The Seventh Circuit relied on Burke's contested testimony. Burke testified that he asked Huarisa at the January 2, 1969 board meeting whether Sundstrand had been told of the accounting reports. Meers was present at this meeting, which was held to approve the Sundstrand merger proposal. The Seventh Circuit held that this event "removed Meers' omission from the putative realm of mere inexcusable neglect." 553 F.2d at 1047.

could disagree that Meers's conduct was reckless. Second, the Seventh Circuit found no evidence to support Meers's defense that Sundstrand was recklessly remiss in not becoming aware of the accounting problems. Yet there is evidence which reasonable persons could find supported Meers's claim that Sundstrand's conduct constituted recklessness.

1. Meers's Conduct Reconsidered

In reviewing Meers's conduct, the objective standard outlined by the Seventh Circuit must be kept in mind. The *Franke* test requires a highly unreasonable omission that constitutes an extreme departure from ordinary care and presents a danger so obvious that the actor must have been aware of it. When viewed against this standard, the facts demonstrate that the determination whether Meers's conduct constituted recklessness was a question for the finder of fact. It should not have been decided as a matter of law.

The SKI 1967 annual report and financial statements showed the deferral by SKI of large amounts of preproduction costs; SKI intended to amortize the costs after the SKI computer project qualified for government contracts. Meers could assume that anyone who looked at SKI's financial condition would be put on notice of this accounting practice, which was not unusual in the 1960's.

The Burke and Ernst & Ernst accounting reports which questioned this practice had been considered by the SKI board of directors on numerous occasions. The directors had their accountant, Price Waterhouse, prepare responses. The intraboard dispute, led by Burke, a director Huarisa had demoted for incompetence, was eventually resolved by the board. The directors deemed the Burke criticism without merit. Meers could justifiably rely on the board's decision in guiding his future conduct.

The SEC concluded that the accounting procedures complained of in the 1967 annual report were not improper. Although Price Waterhouse assured the SEC that it would re-evaluate the situation in preparing the 1968 annual report, Meers could justifiably conclude that there was nothing improper about the accounting procedures and hence that the Burke and Ernst & Ernst accounting reports did not merit disclosure.

Reasonable persons could disagree on the question whether Meers was reckless in light of these facts. The Seventh Circuit erred when it held that this question could be decided as a matter of law.

2. Meers's Defense Reconsidered

The Seventh Circuit allowed Meers to assert the affirmative defense of nonreliance on the omissions; Meers would not be held liable if he could prove that Sundstrand's contributory fault was "somewhat comparable to that of [Meers]."[67] The court found "nothing in the record that remotely suggest[ed] that Sundstrand was recklessly remiss in not ferreting out on its own the information contained in the Burke and Ernst & Ernst reports"[68] before executing the stock

67 *Id.* at 1048.
68 *Id.*

option transfer agreement with Huarisa. Certain facts, however, more than "remotely suggest" that Sundstrand was reckless.

The 1967 annual report apprised Sundstrand of SKI's deferral of preproduction costs. The matter had been discussed with Huarisa in November, 1968. When Sundstrand began its full-scale investigation of SKI on January 2, 1969, Ethington told the investigating team to research this item thoroughly. Sundstrand knew of the accounting procedures.

Sundstrand acted hastily to consummate the stock option transfer agreement, and for good reason. Sun Chemical had offered to purchase the shares on which Huarisa had a right of first refusal. Huarisa was obligated to exercise his right of first refusal no later than January 9, 1969, or his right would expire. Sundstrand could not postpone the execution of the transfer agreement pending the outcome of the investigation begun two days before; to do so would have resulted in the loss of the block of shares to Sun Chemical. Although Sundstrand could not spend more time considering its agreement with Huarisa without losing the stock, it could have made inquiries of Meers or others concerning the deferral of preproduction costs. Indeed, Sundstrand's concern about the deferrals was confirmed by its own investigation completed eleven days after signing the transfer agreement. As the Seventh Circuit admitted: "In hindsight, the reports may not have told more than Sundstrand already knew from its investigation of SKI."[69]

The Seventh Circuit found that this evidence did not remotely suggest that Sundstrand acted recklessly. But reasonable persons could differ on the question whether Sundstrand acted recklessly when it entered a multimillion dollar stock deal after it had been put on notice from SKI's financial statements that a large sum of deferred preproduction costs might have to be written off at one time. The case should have been remanded for further findings on the matter.

V. Conclusion

Sunstrand's holding that recklessness is within the ambit of the *Hochfelder scienter* requirement for liability in a private rule 10b-5 cause of action provides needed guidance for federal courts in the absence of any further direction from the Supreme Court. The test for nondisclosure is particularly detailed. Conduct will be compared with the objective standard that is the basis for finding criminal and civil liability for recklessness in other areas of the law. The result in *Sundstrand,* although correctly stated, was reached on the dubious authority of *Meister Brau* and a cursory deferral to the common law. This comment has shown, however, that the holding in *Sundstrand* is well-embedded in the common law.

The Seventh Circuit's application of the facts of this case to its correctly articulated standard is questionable. It found liability as a matter of law when reasonable persons could disagree with the result. This troublesome application of the facts will lessen the impact *Sundstrand* might otherwise have on the development of 10b-5 law.

69 *Id.* at 1049 n.30.

In its brief lifetime, the *Sundstrand* recklessness standard has been cited twice by the Seventh Circuit and by two district courts.[70] No court that has considered the issue presented in *Sundstrand* has held recklessness insufficient for 10b-5 liability. Because of the severity of the recklessness standard, it is indeed unlikely that the *Sundstrand* standard will not be followed.

Although the *Sundstrand* court extended the scope of *scienter* by allowing a private 10b-5 action to sound in recklessness, it is doubtful that there will be an increase in the amount of 10b-5 litigation. To prove that a defendant acted intentionally, a plaintiff must show that the defendant had knowledge that the consequences of his actions were substantially certain to follow; to prove that a defendant acted recklessly, a plaintiff must show that the defendant had knowledge of circumstances creating the high degree of danger to the plaintiff. The logical nicety of this distinction is easily blurred when a trier of fact must sift through a plethora of complex evidence typical in a securities fraud action. The practical result may be that it is no less burdensome to prove recklessness than to prove intent.

Daniel M. Snow

70 Sanders v. John Nuveen & Co. Inc., 554 F.2d 790 (7th Cir. 1977); Wright v. The Heizer Corp., CCH FED. SEC. L. REP. ¶ 96,101 (7th Cir. 1977); In re Clinton Oil Company Securities Litigation, CCH FED. SEC. L. REP. ¶ 96,015 (D. Kan. 1977); Stern v. American Bankshares Corp., 429 F. Supp. 818 (E.D. Wis. 1977).

SECURITIES REGULATION—RULE 10b-5 IS VIOLATED WHEN SELF-DEALING BOARD MAJORITY FAILS TO DISCLOSE TO SHAREHOLDERS.

*Wright v. Heizer Corporation**

I. Introduction

The Seventh Circuit Court of Appeals in *Wright v. Heizer Corporation,* dealt with the question of the propriety of an investment corporation's involvement in several "self-dealing" securities transactions during and after its gradual takeover of another corporation. Specifically, the court was called on to evaluate the defendant's "duty to disclose" when it controlled the majority of a corporation's board of directors and used that control to promote several transactions to its own benefit but to the detriment of the controlled entity. The Seventh Circuit's decision that there is such a duty is a significant addition to the body of law arising under Section 10(b)[1] of the Securities Exchange Act of 1934 (S.E.A.) and S.E.C. Rule 10b-5[2] thereunder.

Designed to effectuate the legislative purpose of S.E.A. Section 10(b), Rule 10b-5 proscribes the use of manipulative and deceptive practices in the sale or exchange of securities. Although the rule has been applied to such diverse areas as insider trading on the basis of undisclosed material information,[3] insider "tipping,"[4] issuing misleading corporate publicity,[5] and broker misconduct,[6] the facts of the instant case characterize this as a problem of "corporate mismanagement." It is in the context of cases in that general category that *Wright v. Heizer Corporation* will be analyzed.

As is often the case in securities litigation, the Seventh Circuit had to unravel a series of complex transactions and events during which the relationship

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* 560 F.2d 236 (7th Cir. 1977).

1 15 U.S.C. § 78j (1970) provides in pertinent part:

> 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—
>
> . . . .
>
> (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.

2 17 C.F.R. § 240.10b-5 (1977) 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 any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud.
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3 *See, e.g.,* SEC v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), *cert. denied,* 394 U.S. 976 (1969).

4 *Id.*

5 *See, e.g.,* Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951).

6 *See, e.g.,* Hanly v. SEC, 415 F.2d 589 (2d Cir. 1969).

among the parties changed continually. A brief summary of the facts will facilitate an understanding of the court's rationale.[7]

International Digiosonics Corporation (IDC) was founded by Jordan Ross in 1968 to provide nationally a service of encoding television commercial transmissions. Its service enabled properly equipped advertisers or specialized accounting agencies to electronically monitor broadcasts and ensure that commercials contracted for were in fact transmitted. IDC's initial investor was co-plaintiff Beneficial Standard Corporation (BSC), and its only subsidiary of interest to this case was Talent & Residuals, Inc. (T&R). T&R was another Ross-founded organization which offered to the television industry a service related to that provided by IDC. T&R had been profitably operated by Ross since 1962 and was joined as a subsidiary as a condition of BSC's investment.[8]

In November, 1969, IDC entered into negotiations with the Heizer Corporation on the first of five transactions which formed the basis of the suit. Although the importance of the first three of those transactions is minimized by the unchallenged district court finding of non-liability in each instance,[9] it should be noted that each involved a substantial investment by Heizer, that each significantly strengthened Heizer's *pro forma* equity position in IDC, and that each was accomplished with no Heizer representation on the IDC board of directors. Generally, Heizer was compensated for its investments in these early transactions with shares of preferred stock, IDC notes of indebtedness and warrants to purchase common stock. In addition each agreement included an "antidilution" clause which would automatically reduce the exercise price of the warrants held by Heizer and increase the number of shares purchasable if IDC were to sell common stock at less than Heizer's exercise price of $3.60.[10]

After approval of the third transaction at an IDC shareholders' meeting on May 11, 1971, Heizer's position of influence was apparent. Of the 3,000,000 shares of common stock authorized, Heizer held warrants on 1,304,000, as compared to 840,010 issued to other shareholders and entitled to one vote each at a shareholders' meeting. Of the 350,000 shares of preferred stock authorized, Heizer controlled all 300,000 issued and outstanding and was entitled to 4.4 votes per share for a total of 1,320,000 votes or 61% of the total votes. In addition, Heizer held IDC's notes for $2,200,000 and, as a result of an election held the same day, placed two representatives on the seven-member IDC board of directors.[11]

In the fall of 1971, IDC again sought an investment by Heizer. The resultant fourth IDC-Heizer transaction provided for loans up to $600,000 by

7 Facts are drawn from both the court of appeals' opinion and the opinion of the district court: Wright v. Heizer Corporation, 411 F.Supp. 23 (N.D. Illinois, 1975).

8 560 F.2d at 241.

9 The court explained that the first three transactions were not at issue: "The court then rules that the first three transactions, which it found to be 'open and at arm's length,' could not be attacked . . . [O]n appeal, plaintiffs do not challenge the District Court's ruling on the first three transactions." *Id.* at 245.

10 *Id.* at 242. In note 2 of its opinion, the court gives the formula for determining the new number of shares purchasable if the antidilution clause were triggered:

$$\frac{\text{old exercise price} \times \text{old number of warrants}}{\text{new exercise price}}$$

11 *Id.* at 243.

Heizer in return for IDC's notes payable on demand after March 31, 1972.[12] In the event Heizer loaned the entire amount and was not repaid, the loan would become convertible into IDC common stock at $1 per share, thereby triggering the antidilution clauses of warrants from earlier transactions. An amendment approved by the board raised the loan ceiling to $850,000 under the same terms and maintained the March 31, 1972, date for payment. Non-payment of the loan by that date would enable Heizer to purchase at $1 per share 5,513,000 shares of IDC common stock,[13] representing 87% of IDC's *pro forma* common stock equity.[14]

Reduced to four members by resignations and the absence of the BSC representative,[15] the IDC board met on November 19, 1971, to consider the fourth transaction. With the two Heizer representatives deferring their votes until the other two directors had voted, the board unanimously approved the transaction and resolved to recommend to the stockholders adoption of an amendment to the certificate of incorporation increasing to 7,000,000 the number of authorized common shares. In lieu of a shareholders' meeting, written consent to the amendment was obtained from 52.4% of IDC's common shareholders.

As the result of yet another election and more resignations, the IDC board in June, 1973, consisted of Jordan Ross, two Heizer nominees, and Paul Roth, the IDC president previously elected by a Heizer majority. On June 8, 1973, the board approved the fifth and final transaction between IDC and Heizer, with only Ross casting a dissenting vote. Under the terms of this agreement, Heizer would refrain until January 2, 1974, from making demand on various IDC notes it held and would make additional loans to the corporation. In return IDC pledged all of the stock of its subsidiary, T & R, as security for repayment on all Heizer loans to IDC on a non-convertible demand note basis entered into since April 14, 1972, as well as the loans made part of this agreement.[16]

Plaintiffs BSC and Wright, both minority shareholders, filed their first complaint in October, 1972, after consummation of the fourth transaction. They later amended their complaint to include the fifth transaction. The plaintiffs alleged that Heizer had effectively gained control of IDC, had failed to make adequate disclosure of its controlling position and other material information, and had abused its control of IDC, all in violation of Rule 10b-5.[17]

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12 *Id.*

13 *See* note 9 *supra.* With a new exercise price of $1.00, and old price of $3.60, and 1,304,000 existing warrants, the number of shares purchasable under old warrants would be: $\frac{3.60 \times 1{,}304{,}000}{1.00} = 3{,}794{,}000$. Heizer would also have the option of converting the loan involved into common stock at $1.00 per share. The net result was that Heizer could purchase shares representing 87% of IDC *pro forma* equity.

14 560 F.2d at 244.

15 411 F.Supp. at 29, 30. The BSC representative, Marcus Loew, was absent from the November 19, 1971, meeting to discuss the proposed loan transaction. He was, however, present at the meeting of March 13, 1972, at which the loan ceiling was raised to $850,000. At that later meeting, his was the only dissenting vote, as the proposal was approved by a 4:1 vote. Loew resigned in June, 1972.

16 560 F.2d at 244, 245.

17 *Id.* at 244; 411 F.Supp. at 30, 31.

II. Court's Holding

The Seventh Circuit in *Wright v. Heizer Corporation* found defendant Heizer liable for 10b-5 violations in connection with both the fourth and fifth IDC-Heizer transactions. In both instances, the court based its finding of liability on Heizer's failure to make adequate disclosure to IDC shareholders.

In dealing with the fourth transaction, the court based its finding of a general duty to disclose on applicable state law. A Delaware statute clearly required shareholder approval for the type of amendment proposed.[18] Although Heizer controlled less than a majority of the board (two of four members), the court found that it "assumed responsibility for the inadequacy of the disclosure when it undertook to control and supervise IDC's communications to its shareholders."[19] Further finding that the disclosure actually made was lacking in information "material" to the issue before the shareholders,[20] the court concluded that Heizer was liable for the inadequacy.

In the fifth transaction the court was faced with the more difficult question of Heizer's duty to disclose when the transaction was not of a nature normally requiring shareholder disclosure. Although the "self-dealing" status of Heizer was not contested, there was no allegation of deception by or of the board of directors. Recognizing the novelty of the issue before it, the court explained: "We are not aware of any prior case in which the court has confronted the issue of who represents the corporation in the middle situation presented here, where a majority, but not all, of the directors are controlled."[21] Nevertheless, the court considered a majority of the board controlled by Heizer and significantly extended the case law in this area by imposing on Heizer a duty to disclose to the shareholders generally. Heizer's admitted failure to do so was the basis of 10b-5 liability for this last transaction. As the court further explained:

> Under these circumstances, Heizer was obliged to disclose the material facts concerning the transaction to the independent shareholders prior to its consummation. This obligation was not fulfilled: the shareholders were first informed of the general terms of the pledge and the reasons therefor two months after the transaction. Thus, we hold that Rule 10b-5 was also

18 The court explained:

> In the case at bar, one critical element of the fourth transaction, the charter amendment increasing the number of authorized shares of common stock from three to seven million, required shareholder approval. Under Delaware law, such an amendment must be approved by a majority of the common stockholders voting as a class . . . Before deciding whether to exercise this power, the shareholders were entitled to full disclosure of all material facts concerning the transaction.

560 F.2d at 247 (footnotes omitted).

19 *Id.* at 248.

20 In evaluating the sufficiency of the disclosure actually made in obtaining shareholder consent, the court applied a test of materiality, enunciated in TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Under this standard, facts are "material" and must be disclosed when "there is a substantial likelihood that a reasonable shareholder would consider [them] important in deciding how to vote." In applying this materiality test, the court rejected Heizer's contention that the shareholders' knowledge that their equity position could be eroded was sufficient. Rather, the terms of the transaction, the process by which shares were valued at $1.00, the alternatives available to IDC, and the true effect of their cumulative voting power, were deemed "material" facts which should have been disclosed to the shareholders. *See id.* at 248.

21 560 F.2d at 249.

violated by Heizer's failure to disclose material facts to the corporation in the fifth transaction.[22]

Relief provided by the Seventh Circuit included cancellation of the conversion feature of the fourth transaction, cancellation of price adjustment through that transaction and nullification of the charter amendment increasing the number of shares authorized. In addition, the pledge of T & R stock was nullified, the maturities of Heizer's loans to IDC were ordered adjusted and Heizer was enjoined from failing to disclose to IDC common shareholders material facts concerning future securities transactions with IDC.

III. Discussion: Fitting *Wright v. Heizer Corporation* into the Scheme of 10b-5 Corporate Mismanagement Cases

In holding that a board whose majority is engaged in self-dealing must disclose the terms of a proposed transaction to the stockholders, the Seventh Circuit has expanded a nondisclosure standard in 10b-5 corporate mismanagement cases beyond prior limits. The decision continues a trend away from what has been deemed an inappropriate "deception" standard [23] and takes a step toward filling the void left by recent curtailment of federal action in "breach of fiduciary duty" cases.[24] To understand the significance of *Wright v. Heizer Corporation,* it must be considered in the evolutionary line of corporate mismanagement cases into which it fits.

A. Birnbaum *to* Green: *Seeking an Appropriate Standard*

The development of federal law in corporate mismanagement cases reveals a continuing judicial struggle to fix a standard for "fraud" under 10b-5 which includes an element of "deception" while not flatly denying federal relief for breaches of fiduciary duties which may well involve no true deception.[25] A review of the developing law reveals that the courts have been seeking a standard which is both faithful to what is viewed by many as a traditional requirement of deception[26] in 10b-5 cases, and which also affords minority stockholders some protection against a board-controlling party which uses its control to its own benefit and to the corporation's detriment, without necessarily "deceiving" anyone.

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22 *Id.*

23 *See* Sherrard, *Fiduciaries and Fairness Under Rule 10b-5,* 29 VANDERBILT L. REV. 1385, 1391 (1976); Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases,* 86 HARVARD L. REV. 1007, 1009 (1973).

24 *See* text accompanying notes 44-47 *infra. See also* Marshel v. AFW Fabrics Corporation, 533 F.2d 1277 (2d Cir.), *vacated and remanded for determination of mootness,* 429 U.S. 881 (1976).

25 The Second Circuit's efforts in this development have been well documented. *See, e.g.,* Sherrard, *supra* note 23; Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases, supra* note 23; Patrick, *Rule 10b-5, Equitable Fraud and Schoenbaum v. Firstbrook: Another Step in the Continuing Development of Federal Corporation Law,* 21 ALABAMA L. REV. 457 (1969); Jacobs, *The Role of S.E.A. Rule 10b-5 in the Regulation of Corporate Management,* 59 CORNELL L. REV. 27 (1973).

26 *See generally* Sherrard, *supra* note 23, at 1390-91; Jacobs, *supra* note 25, at 469; Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases, supra* note 23, at 1009; 1 A. BROMBERG, SECURITIES LAW: FRAUD §§ 540-542 (1977).

The Second Circuit has been the leader in the judicial development of an appropriate standard for 10b-5 mismanagement cases. Although recent cases have marked a significant break in this pattern,[27] the Seventh Circuit has generally followed the guidance of the Second Circuit and applied the reasoning of its several landmark decisions.[28]

In the first of its important holdings in this field, the Second Circuit in *Birnbaum v. Newport Steel Co.*,[29] began to set the limits for application of Section 10(b) and Rule 10b-5 (then called X-10b-5). In denying minority shareholders standing to challenge a proposed stock sale, the court limited 10b-5's protection to "buyers and sellers" of securities.[30] By its limitation of standing, and its further restriction of 10b-5 to fraud "associated with" securities transactions,[31] the Second Circuit in *Birnbaum* refused to extend 10b-5 beyond prior limits—arguably, the common law limits of "deceit"[32]—and did nothing to dispel the assumption that deception was an element necessary for recovery under 10b-5.

In 1964, the Second Circuit appeared to reject a strict deception standard in favor of an evaluation of disclosure. In *Ruckle v. Roto-American*,[33] the court based 10b-5 liability on a controlling party's inadequate disclosure[34] to minority directors and suggested in dictum that total board control by interested parties would necessitate disclosure to shareholders generally.[35] The Second Circuit soon qualified its position in *O'Neill v. Maytag*[36] in which the court refused to find a self-dealing party with total board control liable without evidence of deception, thereby reasserting a strict deception standard. As the court in *O'Neill* explained:

> Between principal and agent and among corporate officers, directors and shareholders, state law has created duties which exist independently of the sale of stock. While the essence of these duties in some circumstances is honest disclosure, the allegations in the instant case are typical of situations in which deception may be immaterial to a breach of duties imposed under common law principles. The question posed by this case is whether it is

27 *See generally* text accompanying notes 62-67 *infra*.

28 *See, e.g.*, Surowitz v. Hilton Hotels Corporation, 342 F.2d 596 (7th Cir. 1965) applying principles of *Birnbaum*. Dasho v. Susquehanna Corporation (Dasho I), 380 F.2d 262 (1967), deals with *Ruckle/O'Neill* development. Abandonment of Second Circuit leadership is discussed in relation to the later *Dasho* opinion, Bailey v. Meister Brau, Inc., and the instant case. *See generally* text accompanying notes 62-67 *infra*. *See also* Eason v. General Motors Acceptance Corporation, 490 F.2d 654 (7th Cir. 1973).

29 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

30 193 F.2d at 464.

31 The "associated with" requirement has been affirmed but somewhat liberalized in subsequent decisions. *See* Blue Chips Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), and Eason v. General Motors Acceptance Corporation, 490 F.2d 654 (7th Cir. 1973).

32 *See generally* Sherrard, *supra* note 23, at 1390-91; Note, *The Controlling Influence Standard in Rule 10b-5 Corporate Mismanagement Cases*, *supra* note 23, at 1009; 1 A. BROMBERG, *supra* note 26, at § 541.

33 339 F.2d 24 (2d Cir. 1964).

34 The court explained:

> [W]e hold that federal courts have jurisdiction over actions in which the complaint alleges that a corporation has been or may be defrauded into issuing or selling securities through the failure or refusal of some of its directors to disclose to the remaining directors material facts concerning the transactions or the financial condition of the corporation.

339 F.2d at 26.

35 *See* text accompanying note 58 *infra*.

36 339 F.2d 764 (2d Cir. 1964).

> sufficient for an action under Rule 10b-5 to allege a breach of one of these general fiduciary duties where the breach does not involve deception. We think that it is not: At least where the duty allegedly breached is only the general duty existing among corporate officers, directors and shareholders, *no cause of action is stated under Rule 10b-5 unless there is an allegation of facts amounting to deception.*[37]

In 1969, the Second Circuit in *Schoenbaum v. Firstbrook,*[38] once again appeared to displace the deception standard in mismanagement cases. Hailed as enunciating a "new fraud,"[39] the court in *Schoenbaum* found a controlling shareholder liable for abusing his control of the board to buy 500,000 shares of stock at a vastly inadequate price. Although the "controlling influence standard" which the court applied was acclaimed as breaking with the deception requirement and once again asserting federal regulation over the broader field of fiduciary duties,[40] subsequent developments sharply limited the scope of its influence.

In 1972, confronted with an allegedly unfair merger, the Second Circuit in *Popkin v. Bishop*[41] explained its *Schoenbaum* rationale. In emphasizing that the controlling influence test was not meant to exclude an element of nondisclosure, the court stated:

> Thus, it seems clear that our emphasis on improper self-dealing did not eliminate non-disclosure as a key issue in Rule 10b-5 cases. Section 10(b) of the Exchange Act and Rule 10b-5 are designed principally to impose a duty to disclose and inform rather than to become enmeshed in passing judgments on information elicited.[42]

Significantly, the court in *Popkin* not only refused to extend 10b-5 application to mere breaches of fiduciary duties but also continued the equation, first suggested in *Ruckle,* of deception and nondisclosure. In denying federal relief, the court explained:

> We realize that cases based upon Rule 10b-5 in which a court can properly find full and fair disclosure may not be frequent since self-dealing schemes are by nature secretive. . . . But when there has been such disclosure of a merger's terms, it seems unwise to invoke federal injunctive power, particularly since doing so might well encourage resort to the federal courts by any shareholder dissatisfied with a corporate merger.[43]

The inconsistencies of the Second Circuit's holdings in corporate mismanagement cases were apparent by 1976, when that court decided *Green v. Santa Fe Industries, Inc.*[44] *Birnbaum* had suggested a very restricted applica-

37 339 F.2d at 767, 768 (emphasis added).
38 405 F.2d 215 (2d Cir. 1968), *cert. denied,* 395 U.S. 906 (1969).
39 *See* Bloomenthal, *From Birnbaum to Schoenbaum: The Exchange Act and Self-Aggrandizement,* 15 N.Y.L. FORUM 332 (1969).
40 *See generally* note 23 *supra.*
41 464 F.2d 714 (2d Cir. 1972).
42 *Id.* at 719, 720.
43 *Id.* at 720.
44 533 F.2d 1283 (2d Cir. 1976), *rev'd,* Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).

tion of 10b-5 to mismanagement cases, implying retention of a common law "deception" requirement. *Ruckle* discounted the importance of deception and hinted at the equation of nondisclosure to deception. In the same year, however, *O'Neill* reasserted a strict deception element. *Schoenbaum* introduced a "new fraud" concept and applied a controlling influence test as the Second Circuit once again appeared to extend 10b-5 liability to mismanagement and breaches of fiduciary duties without proof of deception. Shortly thereafter, however *Popkin* unequivocally reaffirmed the necessity of proving nondisclosure, apparently repeating the *Ruckle* equation of nondisclosure and deception.

Attempting to resolve the ambiguities of their prior holdings, the Second Circuit in *Green,* in clear and certain terms, held that breaches of fiduciary duties, even absent nondisclosure or deception, were subject to federal scrutiny under 10b-5. The court stated:

> Our later view of the decisions of this Court on the subject of allegations under Rule 10b-5 of breaches of fiduciary duty by a majority against minority shareholders without any charge of misrepresentation or lack of disclosure will, we think, demonstrate that in such cases misrepresentation or lack of disclosure are not essential ingredients of the claim for relief by the minority. But, lest there be any lingering doubt on this point, we now hold that in such cases, including the one before us, *no allegation or proof of misrepresentation or nondisclosure is necessary.*[45]

The Second Circuit thus resolved the uncertainty resulting from its past cases by abandoning deception or nondisclosure as necessary elements of a 10b-5 action. The new rule was, however, short-lived.

The Supreme Court rejected the Second Circuit's reasoning and reversed *Green.*[46] Reemphasizing the necessity of a deception or nondisclosure element, the Supreme Court held that "[T]he cases do not support the proposition, adapted by the Court of Appeals below and urged by respondents here, that a breach of fiduciary duty by majority stockholders, without any deception, misrepresentation, or nondisclosure, violates the statute and the rule."[47] The unequivocal language of the Supreme Court in *Green* makes clear the necessity of a deception or nondisclosure element for liability to attach in 10b-5 corporate mismanagement cases.

A review of the Seventh Circuit's recent treatment of mismanagement cases under 10b-5 indicates that it has rejected the leadership of the Second Circuit in this field and, perhaps in anticipation of the reversal of *Green,* has continued development of a standard which includes an element of deception or nondisclosure. Its decision in *Wright v. Heizer Corporation* represents the most recent step in that development.

B. *The Seventh Circuit*: Wright v. Heizer Corporation *and the expanding disclosure requirement*

Mindful of the Second Circuit's early leadership in the field of 10b-5 liability for corporate mismanagement, it is now appropriate to further analyze the

45 533 F.2d at 1287 (emphasis added).
46 Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).
47 430 U.S. at 476.

Seventh Circuit's decision in *Wright v. Heizer Corporation.* Analysis of the court's rationale and a review of the case law upon which it relies for support reveal that the Seventh Circuit has been responsive to the leadership of the Second Circuit in the area of corporate mismanagement—at least to the time of the *Schoenbaum* decision.[48] Seventh Circuit cases decided after *Schoenbaum,* however, reveal a gradual abandonment of such guidance. These later cases show a unique development and refinement within the Seventh Circuit of a "nondisclosure" standard for mismanagement cases—a standard suggested by the Second Circuit in as early a case as *Ruckle,* but one which has long been subordinated to that Circuit's preoccupation with extending a broader "fiduciary duties" standard to 10b-5 cases.

The general issue posed by *Wright* was the liability of Heizer for allegedly deceptive and manipulative practices in its dealings with IDC. The district court's findings that the first three transactions were "open and at arm's length"[49] were not contested. The Seventh Circuit thus narrowed its attention to the propriety of the fourth and fifth transactions. Unlike the first three agreements, both these latter transactions were accomplished with significant Heizer representation on the IDC board.

Although the lower court's findings of liability were affirmed in each instance, the Seventh Circuit disagreed with the district court's reasoning on both the fourth and fifth transactions, instead exercising its prerogative to "affirm . . . on grounds other than those relied on by that court."[50] Doing so, it rejected the district court's ruling that a breach of fiduciary responsibility, without more, was within the ambit of Rule 10b-5 and that a showing of such a breach shifted the burden to the defendant to prove the fairness of the transaction. Rather, the court based its findings of liability solely on the failure of Heizer to satisfy its duty of disclosure.

In the fourth transaction, the proposed convertible loan of $600,000 to IDC created the possibility that the antidilution clauses of Heizer's warrants would be triggered and that the number of shares purchasable by Heizer would be adjusted upward, well above the number of shares authorized by IDC's certificate of incorporation. The transaction thus necessitated an amendment to the articles of incorporation and state law required shareholder approval for such an amendment. Accordingly, the duty of full disclosure to the shareholders nominally fell to the IDC board of directors. Finding that the Heizer representatives on the IDC board assumed total control of disseminating the necessary information to the shareholders, and further finding that the disclosure actually provided was lacking in information material to the shareholders' decision,[51] the court held Heizer liable under 10b-5 for the inadequacy. Although the court's reasoning with regard to the fourth transaction involves a thorough treatment of a basic 10b-5 case of nondisclosure, it represents no significant modifications or extensions of existing law and requires no further attention.

In the fifth transaction, though, the court was called upon to resolve a

48 *See* note 28 *supra.*
49 *See* note 9 *supra.*
50 560 F.2d at 246.
51 *See* note 20 *supra.*

more delicate problem of 10b-5 disclosure requirements and its decision represents a significant extension of prior law. By the time of the fifth and final transaction—a transaction which involved IDC's pledging the stock of its highly profitable subsidiary T&R—Heizer had two nominees on the four-member board and effectively controlled a third. The pledge of stock was not the sort of action which normally required any action beyond board approval. Furthermore, there was no allegation that the one minority director, Ross, had been in any way deceived by the Heizer group. Rather, full disclosure to Ross was presumed.

As nondisclosure to the general shareholders was conceded, the operative facts may be summarized as follows:

(1) Heizer controlled three-fourths of the IDC board;
(2) it was within the normal power of the board to approve this sort of transaction without shareholder consent;
(3) the minority director was fully informed; and
(4) no disclosure was made to the shareholders.

Approaching this unique predicament,[52] the court first rejected the district court's reasoning that breaches of fiduciary duties are actionable under 10b-5 without an element of deception or nondisclosure. Although such a rationale is not an unreasonable application of the Second Circuit line of mismanagement holdings, the Seventh Circuit in *Wright* apparently viewed the limiting effect of subsequent decisions involving those cases—particularly the reversal of *Green*[53]—as eliminating a broad "breach of fiduciary duties" standard. The court explained:

> They [plaintiffs] argued that self-dealing by a corporate fiduciary that results in the sale of securities for a grossly inadequate consideration has been considered fraud in connection with the sale of such securities. . . . Thus, they argued, findings of a fiduciary duty and gross unfairness in the price of securities sold to the fiduciary are sufficient to establish liability under Rule 10b-5, without proof of deception or nondisclosure of material facts.
>
> In light of the Supreme Court's decision in *Green,* the District Court's reasoning cannot stand, and the plaintiff's argument must be rejected.[54]

Rejecting the broader standard, which would apply 10b-5 to mere breaches of fiduciary duties, the court instead analyzed Heizer's liability strictly in terms of its duty to disclose. In doing so, the court relied heavily on "alternate" interpretations[55] of *Schoenbaum* and *Ruckle* and its own more recent decisions in *Bailey v.*

52 *See* text accompanying note 21 *supra.*
53 Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977).
54 560 F.2d at 246.
55 *Schoenbaum* was initially heralded as enunciating a "new fraud" standard with no deception or nondisclosure element. When the Second Circuit explained its opinion in the later *Popkin* case, it reemphasized the necessity for a deception or nondisclosure element. The Second Circuit explained that what had been deemed an alternative holding in *Schoenbaum*—that nondisclosure was the key to liability—was in fact the true basis of its decision. The "primary" holding, one which would impose a test under 10b-5 encompassing mere breaches of fiduciary duties, was rejected in *Popkin. See* Sherrard, *supra* note 23 and Patrick, *supra* note 25. In *Ruckle,* the Second Circuit stressed a broad standard for fraud, but offered an alternative basis for imposing 10b-5 liability, in dictum. *See* text accompanying note 58 *infra.*

Meister Brau, Inc.,[56] and *Dasho v. Susquehanna Corporation.*[57] The Seventh Circuit's abandonment of the Second Circuit's lead in this area and its refinement of a viable "nondisclosure" standard for 10b-5 mismanagement cases, which it extends and applies here, become clear from an analysis of the *Wright* decision.

In dealing with the relevant aspects of the 1954 *Ruckle* decision, the court in *Wright v. Heizer Corporation* looked beyond the Second Circuit's unsuccessful attempt to discount the necessity of a "deception" element to its consideration in dictum of *who* truly represents a corporation's interests when its whole board of directors is controlled by a self-dealing party. Although factually distinguishable from the instant case—since Heizer did not control the *entire* IDC board—*Ruckle* is important to the court's analysis because the court there rejected the concept that a corporation must be equated with its board and that a board cannot defraud the corporation. As the *Ruckle* court explained:

> We come then to the question of whether it is possible within the meaning of Section 10(b) and Rule 10b-5 for a corporation to be defrauded by a majority of its directors. We note at the outset that in other contexts, such as embezzlement and conflict of interests, a majority or even the entire board of directors may be held to have defrauded their corporation. When it is practical as well as just to do so, courts have experienced little difficulty in rejecting such cliches as the directors constitute the corporation and a corporation, like any other person, cannot defraud itself.[58]

The reasoning of *Ruckle* concerning the nonequation of a corporation and its board, as well as its apparent interchanging of "nondisclosure" and "deception" are incorporated into the court's analysis of *Wright* by its reference to the "alternate" holding[59] of *Schoenbaum.* Though acclaimed for its introduction of a "new fraud" concept to mismanagement cases, the Second Circuit in *Schoenbaum* had supported its apparently revolutionary holding that deception wasn't necessary for a violation of 10b-5 with the seemingly innocuous afterthought that the defendants had in fact *deceived* the shareholders.[60] That is, the court in *Schoenbaum* emphasized the breach of fiduciary duties as the basis of its holding, but bolstered its conclusion with a finding of deception. As the only deception in *Schoenbaum* was the controlling party's nondisclosure of material information, the court in effect not only recognized that a corporation need not be equated with its self-dealing board, but also applied the principle from the dictum in *Ruckle* that nondisclosure and true "deception" are interchangeable for 10b-5 purposes.

The Seventh Circuit, therefore, adopted the reasoning of dictum in *Ruckle* and the alternate holding of *Schoenbaum* as support for its basic proposition in *Wright* that: "When an entire board of directors is controlled by a self-dealing director or shareholder the corporation can only be represented by the inde-

56 535 F.2d 982 (7th Cir. 1976).
57 461 F.2d 11 (7th Cir.), *cert. denied,* 408 U.S. 925 (1972).
58 339 F.2d at 29.
59 560 F.2d at 249. The opinion refers to 405 F.2d at 219-29—that section of *Schoenbaum* interpreted as the Second Circuit's "alternate holding," in which the court as an apparent afterthought supported its conclusion of liability with the finding that the controlling directors "were guilty of deceiving the stockholders." *See* note 55 *supra.*
60 *Id.*

pendent shareholders to whom full disclosure must be made."[61]

Having revealed its allegiance to these less celebrated principles in the Second Circuit's landmark cases, the court then looked to its own holdings in *Dasho v. Susquehanna Corporation,*[62] and *Bailey v. Meister Brau, Inc.,*[63] to complete the background against which *Wright* was to be evaluated.

In its 1972 *Dasho* opinion the Seventh Circuit evaluated in detail the duty to disclose of a controlling, self-dealing party in a securities transaction. Involving a merger of two corporations, the suit was brought derivatively by minority shareholders of the Susquehanna Corporation. The plaintiffs alleged that parties controlling the Susquehanna board were "self-dealing" in the merger transactions, that the transactions resulted in a substantial loss to the corporation and that the controlling board members had violated 10b-5 by failing to disclose the terms of the transactions to the shareholders generally. The court concluded that evidence of culpable nondisclosure was sufficient for submission to a jury.

Although distinguishable from the instant case because it, like *Ruckle,* involved *total* board control, *Dasho* is significant for its firm insistence on an element of nondisclosure. Notably, *Dasho* was decided *after Schoenbaum's* introduction of the "new fraud" and *before Popkins's* limitation of *Schoenbaum,* a fact which suggests that the Seventh Circuit had by 1972 chosen a "nondisclosure" standard for 10b-5 liability and had abandoned its endorsement of the Second Circuit's repeated efforts to forge a standard lacking in an element of deception or nondisclosure. Regardless, *Dasho* is cited in *Wright* as authority both for the proposition that total board control requires shareholder disclosure,[64] and for the equally important converse proposition that ". . . where disinterested directors constitute a majority of the board of directors, disclosure to the board is sufficient."[65] As the cited *Dasho* opinion stated: "Such nondisclosure would not violate Rule 10b-5, however, if a disinterested majority of the board of directors was fully informed about all relevant facts, and if in the good faith exercise of their business judgment they concluded that the transaction was in the best interests of the corporation."[66] Thus, the court in *Wright* viewed *Dasho* as setting the cornerstones for a nondisclosure standard. *Total* board control by a "self-dealing" party will necessitate disclosure to shareholders generally. In cases of minority control, disclosure to the disinterested board majority will be sufficient.

To complete its background analysis, the court cited its recent decision in *Bailey v. Meister Brau, Inc.,*[67] another case in which 10b-5 liability was based on a controlling party's nondisclosure of information material to a "self-dealing" transaction. In *Meister Brau,* a party effectively controlling the entire board of directors of a corporation was held liable for using its control to push through a "self-dealing" transaction in which the valuable assets of that corporation were exchanged for the stock of a different corporation of questionable value. Although it was unnecessary for the court in *Meister Brau* to decide what effect

61 *Id.*
62 *See* note 57 *supra.*
63 *See* note 56 *supra.*
64 *See* text accompanying note 61 *supra.*
65 560 F.2d at 249.
66 461 F.2d at 25.
67 *See* note 56 *supra.*

less than total board control would have on liability, the court in *Wright* restated the "general principle of law" enunciated in *Meister Brau* as follows: "Where the controlling stockholder causes the corporation to engage in a securities transaction in which the stockholder has a conflict of interest, it has the obligation to disclose to the other stockholders information in its possession which reflects on the fairness of the transaction."[68]

Applying these principles to the facts at hand, the Seventh Circuit concluded that Heizer's control of a majority of the board was such that IDC's interests could not be equated with the interests of its board. Furthermore, the interests of the corporation could not be adequately represented by the minority director. Therefore, the court reasoned, Heizer had a duty to disclose to the shareholders generally and was liable under 10b-5 for its failure to do so. Although it had not so extended this duty to disclose in prior corporate mismanagement cases, it had suggested in dictum in *Meister Brau* that such a step was possible. Rationalizing its application of the rule in *Wright,* the court explained that the particular equities of the case necessitated the extension. The court stated:

> Whether this rule, which is somewhat broader than the facts [in *Meister Brau*] required, is to be automatically applied in all the cases it appears to describe, we need not decide. It should be applied here, where the lone minority director did not represent the interests of the second largest common shareholder [BSC] and was completely excluded from the negotiation of the transaction. Under these circumstances, Heizer was obliged to disclose the material facts concerning the transaction to the independent shareholders prior to its consummation. This obligation was not fulfilled . . .[69]

Although not called on to decide whether the rule they established will be applicable to all cases, the Seventh Circuit in *Wright* for the first time imposed a duty on a self-dealing party with *less than total board control* to disclose material information to the shareholders generally. By doing so, the court impliedly recognized the helplessness of a minority director to alone protect the corporation's true interests. It also implicitly rejected the argument that remedies outside the corporation, such as state suits for injunctive relief, are as available to the outnumbered director as they are to the general shareholders. In reaffirming and extending such a standard for assessment of liability in mismanagement cases, the court further rejected the criticism that a nondisclosure standard and expanded disclosure requirement will be ineffective as a deterrent, since perpetrators of fraud are not likely to comply with the rule and announce their illegal intentions.[70]

Rather, the Seventh Circuit's continuing refinement of a nondisclosure test in mismanagement cases is a realistic response to the Supreme Court's sharp limitation of 10b-5 application to breach of fiduciary duties cases. It offers limited federal relief in an area arguably in need of such regulation, without breaching the barriers erected by the Supreme Court. Although its deterrent

68 560 F.2d at 249.
69 *Id.*
70 *See* Sherrard, *supra* note 23, at 1396-97.

effect is untested and the ability of minority shareholders to combat a controlling party unproven, an expanded disclosure requirement at least reinforces the beleaguered minority director, who can now insist on common shareholder disclosure and approval of questionable transactions which he would otherwise be helpless to stop within the corporate framework. Furthermore, in those rare cases in which a confident self-dealing party does make shareholder disclosure of a transaction unfair to the corporation, the proliferation of information to the common shareholders can only enhance the likelihood that true corporate interests will be protected by action outside the corporate structure, such as by state suits.

IV. Conclusion

In reaction to the past uncertainty concerning the standard for "fraud" under Rule 10b-5, the Seventh Circuit in the past few years has continued refinement of a "nondisclosure" standard to assess liability in corporate mismanagement cases. *Wright v. Heizer Corporation* is the latest development in that field, significantly extending prior case law. *Wright* imposes a duty on a self-dealing party with less than total board control to disclose material information on an impending transaction to the general shareholders. Distinguishing prior holdings, the Seventh Circuit in *Wright* for the first time deemed disclosure to a disinterested minority of the board insufficient to relieve a self-dealing majority of 10b-5 liability.

This continued extension of a *disclosure requirement* and corresponding *nondisclosure standard* for liability in 10b-5 corporate mismanagement cases can best be understood as filling the void left by the recent Supreme Court denial in *Santa Fe Industries, Inc. v. Green*[71] of a cause of action based solely on an alleged breach of fiduciary responsibilities, without a showing of deception or nondisclosure. These two standards—one aimed at nondisclosure and one at the broader range of breach of fiduciary duty—developed simultaneously and were often confused in the ambiguous language of Second Circuit decisions. Both were designed as replacements for a traditional "deception" standard which was less appropriate to mismanagement cases than to other 10b-5 violations. The repeated setbacks of the broader standard inspired the expansion of the narrower nondisclosure standard.

Accordingly, the Seventh Circuit in the past few years has reasserted and refined a nondisclosure standard for corporate mismanagement cases. This development occurred while the Second Circuit was striving to forge a broader standard with no deception or nondisclosure element. Although obviously not as inclusive as the broader test struck down in *Green,* the *Wright* test's retention of a deception/nondisclosure element augurs success for its continued application. With its extension in *Wright v. Heizer Corporation,* the disclosure requirement (with its corresponding nondisclosure standard for assessing liability) represents another step toward effective application of Rule 10b-5 to cases of corporate mismanagement.

Lawrence E. Carr III

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

FEDERAL TAXATION—SECTIONS 166 AND 585—COMPUTATION OF ADDITIONS TO BAD DEBT RESERVES BY BANKS: ALLOWABLE INCLUSIONS IN THE LOAN BASE.

*First National Bank of Chicago v. Commissioner**

I. Introduction

One method of accounting for bad debts allowed taxpayers under the Internal Revenue Code is the maintenance of a bad debt reserve.[1] Because additions to the reserve, to an allowable maximum, are deductible from income for tax purposes, it is advantageous for a taxpayer to maximize its additions to this account. The size of the allowable addition to the reserve is determined by applying the average percentage of bad debts over a period of time to the amount of total loans outstanding in the current tax year. During recent years and under current tax law, banks have been permitted by revenue ruling to use a highly favorable, specified percentage figure known as the uniform reserve ratio.[2] As a result, the amount of total outstanding loans has been the banks' only flexible factor in determining permissible additions to the bad debt reserve. The greater the amount of loans outstanding, the larger the allowable addition to the reserve. On various occasions, the Commissioner has promulgated guidelines in an attempt to clarify and define the types of loans includable in the loan base.[3] The issue of permissible inclusions was first addressed by the United States Court of Appeals for the Seventh Circuit in *First National Bank of Chicago v. Commissioner*. The issue has infrequently reached the other circuit courts.[4]

II. Facts

As part of its operations, the taxpayer, First National Bank, maintains a Trust Department and keeps a separate set of books for that department. When cash disbursements made on behalf of the trusts result in an insufficient cash balance in a particular trust account to cover the disbursements,[5] a trust officer authorizes an overdraft. This overdraft appears as a negative balance in the

* 546 F.2d 759 (7th Cir. 1976).

1 I.R.C. § 166(c).

2 Rev. Rul. 92, 1965-1 Cum. Bull. 112; I.R.C. § 585.

3 Rev. Rul. 210, 57-1 Cum. Bull. 94; Rev. Bul. 259, 58-1 Cum. Bull. 116; Rev. Rul. 509, 57-2 Cum. Bull. 145; Rev. Rul. 122, 63-2 Cum. Bull. 98; G.C.M. 25605, 48-1 Cum. Bull. 38.

4 Akron National Bank & Trust Co. v. United States, 510 F.2d 1157 (6th Cir. 1975) considered the loan base issue under I.R.C. § 585, the codification of the revenue rulings considered in *First National Bank*.

5 According to the parties' stipulation of facts, overdrafts occur for the following reasons:

(a) purchase of securities before receipt of funds from a corresponding sale of securities or some other expected source;

(b) payment of taxes, including personal property taxes and estate taxes;

(c) fixed income payments to the income beneficiary as provided in the trust agreement;

(d) payment of necessary, and possibly unexpected or emergency living expenses of the income beneficiary;

(e) payment of legal fees for the trust incurred in probate proceedings and payment for other professional services, such as preparation of a trust tax return; and

(f) payments in distribution of the trust assets pursuant to a trust agreement before receipt of all liquidation proceeds.

546 F.2d at 760 n.1.

individual trust account. The Trust Department summarizes on a daily basis the totals of all such negative balances in the individual accounts. If the overdrafts show a net increase from the preceding day, First National's Commercial Loan Department advances the amount of the increase to the Trust Department. The amount advanced is carried on the Commercial Loan Department's books as a loan to the Trust Department. The Trust Department's books show the advance as a liability.

In the taxable year 1968, First National included advances to its Trust Department totaling $19,136,794.50 in the loan base used for computing its bad debt reserve deduction. The Commissioner challenged the bank's action as unreasonable. The Tax Court disagreed, allowed the inclusion, and granted First National a refund of $85,622.12.[6] On appeal by the Commissioner, the Seventh Circuit reversed the Tax Court's decision. The court held that the loans made by the Commercial Loan Department to the Trust Department were excludable under the guidelines of Revenue Ruling 68-630, which was in effect during the tax year at issue.[7]

III. Treatment of Bad Debt for Tax Purposes[8]

The purpose of a bad debt deduction is twofold: (1) to account for the taxpayer's unrecovered costs of capital investment; and (2) to account for amounts reported as income that ultimately prove uncollectible.[9] Section 166 of the Code permits two alternative methods of deducting bad debts from income. The first method, set forth in § 166(a), uses a specific charge-off to take the deduction in the taxable year during which the debt becomes worthless.[10] The second, or reserve method, set forth in § 166(c), requires maintenance of a fund[11] based on an estimate of the amount of outstanding accounts that will ultimately prove uncollectible.[12] Periodic additions are made to bring the reserve up to this estimated amount.

Where long-term debt is involved, use of the reserve method is especially

6 64 T.C. 1001 (1975).

7 Rev. Rul. 630, 1968-1 Cum. Bull. 84.

8 Congress first provided in 1918 for the deduction from gross income of any debts that became worthless within the taxable year. Revenue Act of 1918, c. 18, 40 Stat. 1057. In 1921, Congress provided for the establishment of reserves for bad debts. Revenue Act of 1921, c. 136, 42 Stat. 227. These provisions were incorporated into the Internal Revenue Code of 1939 as § 23(k)(1) and are currently embodied in the Internal Revenue Code of 1954 as § 166(a) and (c). The Code provisions have changed little in their 60 years of existence.

9 Citizen's Acceptance Corp. v. United States, 462 F.2d 751 (3d Cir. 1972); *see also* Investment Discount Corp. v. Commissioner, 48 T.C. 767, 771 n.6 (1967); 5 MERTENS LAW OF FEDERAL INCOME TAXATION §§ 30.12, 30.69, 30.74, 30.76 (1975); 26 C.F.R. § 1.166-1 (1977).

10 I.R.C. § 166(a) provides:

> General Rule:
>
> (1) Wholly Worthless Debts — There shall be allowed as a deduction any debt which becomes worthless within the taxable year.
>
> (2) Partially Worthless Debts — When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year as a deduction.

11 An actual fund is not set aside for bad debt reserves. The reserve is an accounting entry.

12 I.R.C. § 166(c) provides:

> Reserve for Bad Debts — In lieu of any deduction under subsection (a), there shall be allowed (in the discretion of the Secretary) a deduction for a reasonable addition to a reserve for bad debts.

advantageous for income tax purposes. The taxpayer need not wait until the debt actually becomes uncollectible to take advantage of the deduction. Rather, under the reserve method, the deduction is available immediately, which allows the taxpayer to charge the loss against income for the period in which the loss is actually incurred.[13] In effect, § 166(c) therefore provides the taxpayer with a device for accelerating the deduction for bad debts allowed under § 166(a).[14]

Because reserves are not ordinarily deductible for income tax purposes, courts have attributed significant importance to the permission to deduct additions to bad debt reserves. Yet the only guideline set out in the Code for computing deductible additions to the reserve is that the addition must be "reasonable."[15] In amplifying the meaning of this term, the Commissioner has stated:

> What constitutes a reasonable addition for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of existing reserves.[16]

The ultimate question is the adequacy of the *total* reserve balance at the end of the year to cover expected worthlessness of outstanding debts; it is not whether the proposed addition is sufficient to absorb expected losses on loans made during the taxable year.[17] It is hardly surprising, therefore, that considerable litigation has occurred to resolve disputes between taxpayers and the Commissioner on the reasonableness of additions to bad debt reserves.

IV. Computing Reasonable Additions to Bad Debt Reserves

Commercial banks and non-bank taxpayers essentially employ similar methods of computing tax-deductible additions to bad debt reserves. The computation involves two factors: a ratio factor, or the percentage of debts expected to become uncollectible; and a base factor, or the total amount of debt outstanding.

13 Further advantages of the reserve method of accounting for bad debts include: (1) reserves allowed taxpayers have generally been larger than their actual bad debts; and (2) in the year the reserve is established, a limited double deduction is allowed. 34 AM. JUR. 2d *1976 Federal Taxation* § 6485 (1976).

14 Courts have recognized and commented on the advantages of a reserve method of accounting. In Union National Bank v. United States, 237 F. Supp. 753, 756 (N.D. Ohio 1965), the court stated:

> The reserve method is a means of taking an accounting loss in advance of an individual account actually going bad. Additionally, use of a reserve levels the cyclical trends of bad debts so that they are not bunched in "bad times" when income with which to offset them is lowest.
>
> The reserve makes possible a truer reflection of the worth of loans by permitting taxpayers to currently deduct, from present receivables, the bad debt losses which will be incurred in the future, thereby avoiding payment of a tax in the year the debt is incurred when the tax could not be recovered until some future times when the debt goes bad.

15 I.R.C. § 166(c).

16 Treas. Reg. § 1.166-4(b)(1), T.D. 6403 (1959), amended by T.D. 6728 (1964); T.C. 7444 (1976); Travis v. Commissioner, 406 F.2d 987 (6th Cir. 1969).

17 Worthingham Machinery Co. v. United States, 520 F.2d 160 (10th Cir. 1975); James A. Messer Co., 57 T.C. 848 (1971); Dixie Furniture Co. v. Commissioner, 390 F.2d 139 (8th Cir. 1968); Ira Handelman, 36 T.C. 560 (1961); S.W. Coe & Co. v. Dallman, 216 F.2d 566 (7th Cir. 1954); 5 MERTENS, LAW OF FEDERAL INCOME TAXATION § 30.69 (1975).

The base factor multiplied by the ratio factor gives the amount of the allowable addition to the bad debt reserve.

A. *The Ratio Factor*

The formula for establishing the appropriate ratio factor to be applied in calculating the allowable reserves was originally established in *Black Motor Co.*[18] In this case, the Bureau of Tax Affairs approved the use of a six-year moving average, which consisted of the current taxable year and the five preceding years, to establish the appropriate ratio factor.[19] Under this formula, the amount allowable for bad debt reserves is computed by applying the ratio of the average of the accounts and notes receivable outstanding at the end of the current tax year and the preceding five years to the average of the debts actually charged off during the same period.[20] Although the *Black Motor Co.* formula has been severely criticized by legal and tax scholars for its tendency to produce a ratio that does not approximate actual experience,[21] it has been upheld by most courts[22] and accepted by the Commissioner as a reasonable,[23] although not exclusive[24] means to compute bad debt reserves. Furthermore, Congress has specifically approved the use of this formula by commercial banks through its inclusion in § 585 of the Code, effective in 1969.

B. *The Base Factor*

The outstanding debt used in calculating the ratio factor and in applying that ratio to the current year becomes the base factor in the equation. The debt base may include only those debts that arise from a *bona fide* debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money.[25] This base may not, however, include registered securities or securities with interest coupons issued by a corporation or by a government or its political subdivisions; contingencies such as disputed items, bail forfeitures or advances to clients in contingent fee cases; or extraordinary losses. Because bad debt reserves cannot be maintained to cover anticipated losses on these types of

18 41 B.T.A. 300 (1942), *aff'd* 125 F.2d 977 (6th Cir. 1942).

19 The *Black Motor Co.* formula consists of four basic steps:
(1) find the ratio of the total of the net bad debts for the taxable year and the five preceding years to the total accounts and notes receivable for the same six-year period;
(2) apply this ratio to the total receivables as of the last day of the taxable year;
(3) add to the figure arrived at in (2) the total amount of bad debts charged to the reserve during the taxable year, and substract the amount of recoveries in the taxable year; this is the "total reserve requirement" for the year;
(4) subtract from the total reserve requirement the balance in the reserve at the end of the immediately preceding taxable year. The result is the amount deductible as a "reasonable" addition to the reserve for the taxable year.
2 CCH Stand. Fed. Tax Rep., ¶ 1624.0992 (1977).

20 2 CCH Stand. Fed. Tax Rep., ¶1624.0992 (1977).

21 Whitman, Gilbert & Picotte, *The Black Motor Bad Debt Formula: Why it Doesn't Work and How to Adjust It,* 35 JOURNAL OF TAXATION 366 (1971); Goldstine, *Is the I.R.S. Formula for Computing Bad Debt Reserve Deductions on the Way Out?,* 27 JOURNAL OF TAXATION 286 (1967); Farber and Hutton, *The Black Motor Formula and Reserves for Bad Debts,* 35 RETAIL CONTROL 69 (1967); Durham, Jr., *Bad Debt Deductions and Reserves for Banks,* 82 BANKING LAW JOURNAL 786 (1965).

22 S. W. Coe & Co. v. Dallman, 216 F.2d 566 (7th Cir. 1954).

23 Rev. Rul. 362, 1976-2 Cum. Bull. 45.

24 *See, e.g.,* J. M. Richardson v. Commissioner, 330 F. Supp. 102 (S.D. Tex. 1971); Duffey v. Lethert, 63-1 U.S.T.C. ¶ 9442 (1963).

25 Treas. Reg. § 1.166-1(c), T.C. 6403 (1959), amended by T.D. 6996 (1969).

transactions, they cannot form part of the debt base used in computing allowable additions to bad debt reserves.[26]

To summarize, the basic procedure involved in calculating allowable additions to bad debt reserves is first, to compute the taxpayer's total allowable accounts receivable and outstanding debts for the taxable year. A percentage figure calculated on a base of six years' experience or by some other reasonable method is then applied to this total.[27] If the resulting figure is greater than current reserves,[28] the reserve can be increased. The taxpayer has the option of either deducting the addition in the current year[29] or deferring the allowable addition to future tax years.[30] On the other hand, if the figure is less than current reserves, the taxpayer is not required to reduce his reserve.[31] If there are excessive reserves, the Treasury can limit or bar further deductible additions.[32]

V. Bad Debt Reserves as Applied to Banks

In general, a taxpayer may be assured that an addition to bad debt reserves computed under the *Black Motor Co.* base factor/ratio factor formula will meet

26 34 AM. JUR. 2d *1976 Federal Taxation* § 6486 (1976).

27 Consider the following example of the computation of the ratio factor under the *Black Motor Co.* formula:

Year	Receivables at year end	Bad Debt Loss	Bad Debt Recoveries
1	$18,000	$795	$75
2	17,500	875	80
3	18,500	740	50
4	17,000	765	75
5	18,000	995	90
6*	19,000	570	50
Average	$18,000	$790	$70

*Current Year

Reserve, December 31, year 5: $840

Step (1): Compute the ratio;
($790 ÷ $70) + $18,000 = 4%

Step (2): Apply the ratio to current year receivables; $19,000 x 4% = $760

Step (3): Add to the figure obtained in Step (2) the total amount of bad debts charged to the reserve during the taxable year, and subtract the amount of recoveries in the taxable year;

$760
+570 Bad debt losses charged to reserve
— 50 Bad debt recoveries

$1280 Total reserve requirement

Step (4): Subtract the reserve at the end of the immediately preceding taxable year (year 5).

$ 1280
— 840 Reserve, year 5

$ 440 "Reasonable" addition to reserve for year 6.

28 Current reserves are reserves for the prior taxable year minus recoveries less losses charged to the reserve in the taxable year.

29 It is the addition to the reserve that is deductible, not the reserve itself. I.R.C. § 166(c); Proctor Shop, Inc., 30 B.T.A. 721, *aff'd*, 82 F.2d 792 (9th Cir. 1936).

30 Rev. Rul. 92, 1965-1 Cum. Bull. 112, supplemented by Rev. Rul. 26, 1966-1 Cum. Bull. 41.

31 *Id.*

32 Morris Plan Industrial Bank v. Commissioner, 151 F.2d 976 (2d Cir. 1945); Ehlen v. United States, 323 F.2d 535 (Ct. Cl. 1963).

the § 166(c) reasonableness requirement. Special guidelines have, however, been promulgated by the Internal Revenue Service to assist banks in computing their ratio and base factors. These guidelines vary from those accepted by the Commissioner as reasonable for taxpayers other than banks. To evaluate the Seventh Circuit's treatment of the base factor issue in *First National Bank,* a brief summary of the development of the ratio factor/base factor formula for banks prior to the case is necessary.

A. *The Ratio Factor—Banks*

In 1947, the Commissioner published Mimeo. 6209,[33] which provided for computation of the ratio factor for banks[34] on the basis of a twenty-year moving average that consisted of the current tax year and the previous nineteen years.[35]

33 Mimeo. 6209, 1947-2 Cum. Bull. 26.

34 The term "banks" has had various meanings in various government promulgations. In 1947, the term was defined in Mimeo. 6209, 1947-2 Cum. Bull. 26 as follows:

> (8) The term "banks" as used herein means banks or trust companies incorporated and doing business under the laws of the United States . . . , of any state, or of any territory, a substantial part of the business of which consists of receiving deposits and making loans and discounts.

Rev. Rul. 92, 1965-1 Cum. Bull. 112, defined the term in a manner similar to the definition in Mimeo. 6209, and added:

> Such term does not include a mutual savings bank not having capital stock represented by shares, a domestic building and loan association as defined in section 7701(a)(19) of the Code, or a cooperative bank as defined in section 7701(a)(32) of the Code.

In 1968, the definition was expanded to include foreign banks. Rev. Rul. 524, 1968-2 Cum. Bull. 83 provided:

> The taxpayer, a corporation incorporated only under the laws of a foreign country, licensed by the State of X to operate as a bank . . . and otherwise qualifies as a bank under Rev. Rul. 65-92, may compute the addition to its reserve for bad debts . . . under the provisions of that Revenue Ruling with respect to loans the interest on which is from sources within the United States even though it is not incorporated under the laws of the United States.

I.R.C. § 585, effective for taxable years after July 11, 1969, defines "bank" as:

> (1) any bank (as defined in section 581) other than an organization to which section 593 applies, and
>
> (2) any corporation to which paragraph (1) would apply except for the fact that it is a foreign corporation, and in the case of any such foreign corporation this section shall apply only with respect to loans outstanding the interest on which is effectively connected with the conduct of a banking business within the United States.

I.R.C. § 581, to which § 585 refers, defines the term "bank" as meaning:

> a bank or trust company incorporated and doing business under the laws of the United States (including laws relating to the District of Columbia) or of any State a substantial part of the business of which consists of receiving deposits and making loans and discounts, or of exercising fiduciary powers similar to those permitted to national banks under the authority of the Comptroller of the Currency, and which is subject by law to supervision and examination by State, or Federal authority having supervision over banking institutions. Such term also means a domestic building and loan association.

I.R.C. § 593, to which § 585 also requires, applies to "any mutual savings bank not having capital stock represented by shares, domestic building and loan association, or cooperative bank without capital stock organized and operated for mutual purposes without profit."

35 Basically the procedure is as follows:

> (1) the bank computes its bad debt losses for each of the preceding twenty years (including the current taxable year) and applies this to the total loans outstanding at the end of each year;
>
> (2) the twenty loss ratios so obtained are averaged to obtain the average loss ratio. This ratio is known as the "average experience factor";
>
> (3) the bank then adds to its reserves an amount equal to the average loss ratio multiplied by the loans outstanding at the end of the current year; provided,
>
> (4) that the amount added to the reserve cannot bring the total reserve to more than three times the amount computed in step (3) above.

Union National Bank of Youngstown v. United States, 237 F. Supp. 753 (N.D. Ohio 1965).

Banks that had not operated for a full twenty years were permitted to use substituted experience in the computation.[36]

The expressed intention behind specification of the twenty-year period was to span a period that would likely include good as well as bad loan collection years.[37] Careful examination of Mimeo. 6209 indicates, however, that the guidelines allowed banks clearly preferential treatment over non-bank taxpayers who used the reserve method of accounting for bad debts. The twenty-year base permitted banks to include the heavy loss years of the Depression era in their ratio. This of course increased the overall average loss ratio and consequently allowed the maintenance of comparatively large bad debt reserves.

This favorable treatment was continued in effect by Revenue Ruling 54-148.[38] By 1953, the twenty-year moving average applied to the years 1934-1953. Banks were thus no longer able to include the Depression years in their ratio computations. Yet the reserve maintained on the basis of Depression era figures were by this time so high as to disallow further deductible additions. Consequently, Revenue Ruling 54-148 allowed banks to use the average of *any* twenty consecutive years of their own experience after the year 1927. Further, consistent with Mimeo. 6209 if a bank selected a twenty-year period that included years during which it was not in existence, that bank could use substituted experience.[39]

Mimeo. 6209 and Revenue Ruling 54-148 were superceded by Revenue Ruling 65-92,[40] which was in effect during the tax year in question in *First National Bank*. The policy of extending favorable treatment to banks in the computation of their ratio factor was perpetuated by this ruling. Under Revenue Ruling 65-92, commercial banks were allowed to use either a uniform reserve ration of 2.4% or a ratio computed on the basis of their individual experience based on a six-year moving average, whichever was greater. In the government's

36 For any years that a bank existed, it was required to use its own experience; the use of substituted experience was allowed only for other years. Rev. Rul. 350, 1957-2 Cum. Bull. 144. The disallowance of substituted experience for years that a bank existed has been upheld by the courts. First National Bank v. Commissioner, 368 F.2d (7th Cir. 1966); First Commercial Bank, 45 T.C. 175 (1965); First National Bank of La Feria, 24 T.C. 429 (1955), *aff'd*, 234 F.2d 868 (5th Cir. 1956); Union National Bank & Trust Co. of Elgin, 26 T.C. 537 (1956).

37 First National Bank v. Commissioner, 368 F.2d 164 (7th Cir. 1966).

38 Rev. Rul. 148, 1954-1 Cum. Bull. 60.

39 *See* note 36 *supra*.

40 Rev. Rul. 92, 1965-1 Cum. Bull. 112.

41 Announcement 65-26, based on Treasury Dept. Release D-1537, March 15, 1965, I.R.B. 1965-14. The uniform reserve ratio was the product of a study conducted by the Treasury Department with the cooperation of the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Comptroller of the Currency, and the commercial banking industry. The uniform reserve ratio was "designed to minimize the great disparities in reserve ceilings" disclosed by that study to exist in the banking industry, as demonstrated by the following statistics:

No. of Banks	Reserves as a % of loans
1412	
4076	
1556	Less than 1%
1092	1 – 3%
	3 – 5%
8136	
— 100*	Less than 5%
8036	

* Treasury figures added incorrectly by 100.

words, the 2.4% uniform reserve ratio "reflects a fair distribution of the benefits of previous rulings."[41] It must be reiterated, however, that the previous rulings referred to by the government allowed computation of bad debt reserves based on high-loss Depression years. At the time of the enactment of Revenue Ruling 65-92, had banks been required to use the same method as non-bank taxpayers to compute the ratio factor, the resulting ratio would have been significantly below the 2.4% figure.[42] First National used the favorable 2.4% uniform reserve ratio in computing its reserves for bad debts for 1968, the tax year at issue in the instant case.

B. The Loan Base—Banks

By applying the 2.4% ratio factor to its outstanding loans, First National presumably had chosen the maximum allowable ratio factor. From the bank's viewpoint, the loan factor, that is, the amount of loans outstanding, was the only variable that remained in the bad debt reserve formula.[43] To compute this loan base amount, First National was required to rely on various revenue rulings that defined the nature of the loans includable in the base factor for computing additions to bad debts.[44]

In outlining the computation of the twenty-year average experience factor, Mimeo. 6209 also attempted to characterize the loans includable in deriving the average. It provided, first: that the average should be computed on loans comparable in nature and risk to those outstanding at the close of the taxable year involved; that government insured loans should be eliminated from prior year accounts of past losses; and that losses not in the nature of bad debts resulting from the ordinary course of business should be eliminated in computing percentages of prior losses. Mimeo. 6209 further provided that only loans in which an element of risk was present should be considered. Finally, items which had never been included in income were also excluded in computing additions to reserves for bad debts.[45]

Further clarification of "certain questions regarding the eligibility of items for inclusion in the loan base by banks using the uniform reserve ratio method of computing annual additions to reserves for bad debts"[46] appeared in Revenue Ruling 68-630,[47] which was in effect during the tax year under consideration in *First National Bank*. Sections 3 through 8 of the ruling specifically excluded certain types of loans from the loan base. In addition, § 9 stated:

> Determination of a Representative Loan Base.
> A bank may compute the addition to its reserve for bad debts on the

42 In 1969, four years after the publication of Rev. Rul. 65-92, if banks had built up their bad debt reserves on the basis of their own experience over six years, they would, on the average, have been allowed to build up a bad debt reserve on a ratio of approximately 0.2%. [1969] U.S. Code Cong. & Ad. News 2188, Pub. L. 91-172, § 431 (Dec. 30, 1969).

43 Obviously the bank would otherwise have used the larger percentage computed on the basis of its experience over six years to maximize allowable reserves.

44 *See* note 4 *supra*.

45 Mimeo. 6209, 1947-2 Cum. Bull. 26; *see also* Central Bank Company v. Commissioner, 329 F.2d 581 (6th Cir. 1974); 5 Mertens, *The Law of Federal Income Taxation* § 30.12 (1975).

46 Rev. Rul. 630, 1968-1 Cum. Bull. 84.

47 *Id.*

> basis of loans outstanding at the close of its taxable year, except that any loan outstanding on such date that is not representative of the bank's ordinary portfolio of outstanding customer loans must be excluded from the loan base. If a loan is entered into or acquired for the purpose (whether or not it is the primary purpose) of enlarging the otherwise available bad debt deduction, it will be presumed that the loan resulting from such transaction is not representative of the bank's ordinary portfolio of outstanding customer loans.[48]

First National argued that § 9 was not an independent basis for excluding nonrepresentative loans from the bank's loan base but merely a summary of the "laundry list" of excluded items catalogued in the preceding six sections. The bank therefore contended that if the loans to the Trust Department did not fall within the exclusions of §§ 3 through 8, the loans were includable in the loan base.

A determination of the relationship of § 9 to the other sections of Revenue Ruling 68-630 had not been made by any circuit court prior to *First National Bank*. In the Tax Court, the issue had been considered on two occasions, one of which was the court's decision in the instant case. Yet the conclusions in the two cases directly conflicted.[49] In response to First National's argument that § 9 was not an independent basis for excluding loans, the Tax Court agreed that the section simply underscored the distinction between customer loans and investment vehicles implicit in the preceding sections of the revenue ruling.[50] Despite this holding, the court reached a contrary decision in a later case and held that § 9 constituted a separate ground for exclusion in addition to those listed in §§ 3 through 8.[51] The Seventh Circuit adopted the latter decision, primarily on a construction basis. The court concluded that because revenue rulings contain no superfluous language and thus should be given their plain meaning, § 9 constituted an independent basis for exclusion. An analysis of the IRS's intent and the relevant case law indicates that the Seventh Circuit's conclusion, if not its reasoning, was correct.

VI. Criteria for Exclusion from the Loan Base

To determine the validity of the bank's argument that the transactions set out in §§ 3 through 8 were excludable because they were not "representative of the bank's ordinary portfolio of outstanding customer loans"[52] and that § 9 merely summarized this criterion for exclusion, §§ 3 through 8 must be examined. These sections excluded the following transactions from the loan base:

§ 3. Interbank Deposits and Loans:[53]

48 *Id.* at § 9.
49 Industrial Valley Bank & Trust Co., 66 T.C. 272 (1976); First National Bank of Chicago, 64 T.C. 1001 (1975).
50 First National Bank of Chicago, 64 T.C. 1001 (1975).
51 Industrial Valley Bank & Trust Co., 66 T.C. 272 (1976).
52 Rev. Rul. 630, § 9, 1968-1 Cum. Bull. 84.
53 *Id.* at § 3.

Excluded under this section were any deposits in or loans to other banks, including funds represented by certificates of deposit or instruments evidencing deposits available for withdrawal. Loans of this nature were excluded regardless of whether they took the form of repurchase agreements or similar transactions. These transactions are frequently made to adjust liquidity positions, for purposes of investment, or for the convenience of the lender/depositor, the borrower, or its customers;

§ 4. Cash Collateral:[54]

Loans to customers were excluded in cases where the lending bank possessed the right to specific cash items or cash balances under its control, such as cash deposits evidenced by passbooks or certificates of deposit. The fact that a borrower was required to maintain a minimum, average, or compensating balance did not, however, automatically exclude the loan from eligibility in the loan base. An overdraft could be included in the loan base, regardless of whether or not other deposit accounts of the same customer had balances in excess of the overdraft;

§ 5. Unearned Discount or Interest Receivable:[55]

In situations where banks purchase acounts receivable or notes at less than face value, an unearned discount or interest receivable is reflected in the face amount of the outstanding loans for accounting purposes. Because this discount or interest is unearned, it is not reported as income and, consequently, was excluded from the loan base;

§ 6. Government Insured or Guaranteed Loans:[56]

The term "government loans" has been interpreted to include both loans made directly to the government and loans made to a third party which are insured by the government. The term "government" has been further interpreted to mean the federal government, thus allowing inclusion of loans made to or guaranteed by state or local governments;[57]

§ 7. Investments in Debt Securities:[58]

Bonds or notes of corporations or municipalities purchased by a bank for investment purposes or for taking advantage of favorable tax consequences on interest received on the debt securities were excluded from the loan base;

§ 8. Money Market Investments:[59]

54 *Id.* at § 4.
55 *Id.* at § 5.
56 *Id.* at § 6.
57 State Bank of Albany v. United States, 530 F.2d 1379 (Ct. Cl. 1976).
58 Rev. Rul. 630, § 7, 1968-1 Cum. Bull. 84.
59 *Id.* at § 8.

Under federal regulations, banks must maintain specified liquidity positions based on a ratio of cash deposits on hand to demand deposits. Maintenance of this liquidity position requires the short-term sale or loan of federal funds or the acquisition of short-term commercial paper on the open market. Transactions of this nature were also excluded.

As the Tax Court concluded in *First National Bank*, it is immediately apparent that the loans set out in §§ 3, 5, 7 and 8 of the Revenue Ruling more closely represent investment activities than typical customer loan activity. In the language of the revenue ruling, they are "functionally related to the trading or investment position of banks rather than the lending position of banks."[60] Therefore, an examination of these sections supports the bank's "laundry list" theory.

Yet an examination of §§ 4 and 6 does not necessarily lead to a similar conclusion. First, government insured loans or loans for which cash collateral is held cannot necessarily be treated as investment vehicles rather than customer loan activity. On the contrary, government insured or guaranteed loans and cash collateral loans far more closely resemble typical customer loan activity in terms of the form and procedure for processing these loans. Comparison of the government insured and cash collateral loans to the strict investment activities set out in §§ 3, 5, 7 and 8 supports this argument. Therefore, it is not clear that these loans were excluded from the loan base on the basis of their nonrepresentativeness.

Although loans "representative of the bank's ordinary portfolio of outstanding customer loans"[61] are expected to contain some element of risk, the critical distinction is whether these loans are excluded as nonrepresentative because they lack that risk element or because they are no-risk without any specific determination of their representative nature. The "risk" criterion represents the more compelling distinction for several reasons. First, in Mimeo. 6209 the Commissioner specifically emphasized the risk element involved in making the loan, stating that ". . . the average should be computed on loans comparable in their nature *and risk involved* to those outstanding at the close of the current taxable year involved."[62] Revenue Ruling 65-92, which superceded Mimeo. 6209 and established the uniform reserve ratio, specifically continued to exclude government insured or guaranteed loans from the loan base. This ruling also emphasized these loans' clear lack of risk rather than their investment or nonrepresentative nature. Revenue Ruling 68-630, which applied to the taxpayer bank, expanded and explained Revenue Ruling 65-92. Therefore, it is a logical conclusion that the Commissioner intended to exclude no-risk loans from the loan base.

The exclusion of §§ 4 and 6 loans from the loan base because of their no-risk nature is also consistent with the purpose of bad debt reserves. An examination of this purpose provides an additional reason for emphasizing risk over nonrepresentativeness. A bad debt reserve allows the taxpayer: (1) to charge bad debt losses against income for the period in which the losses are actually incurred as a result of accounts which *subsequently prove uncollectible;* and (2) to show

60 Rev. Rul. 630, 1968-1 Cum. Bull. 84.
61 *Id.* at § 9.
62 Mimeo. 6209, 1947-2 Cum. Bull. 26.

the *estimated realizable value* of outstanding accounts.[63] No-risk loans obviously never subsequently prove uncollectible and their estimated realizable value, for all practical purposes, is their actual face value. No real protection is afforded the bank by setting aside bad debt reserves for loans of this type. Thus, the incorporation of no-risk loans in the loan base results in a distorted reserve in terms of anticipated actual losses.

Bad debt reserves were intended to allow an alternative method of tax accounting for bad debts[64] and were not intended simply to allow banks that used the reserve method an additional tax deduction. To permit inclusion of no-risk loans in the loan base would in effect allow a tax deduction based on the selection of accounting method rather than on any real prediction of loss and would thus penalize banks that opted to use the charge-off accounting method for bad debts. Since the loans would never fail, they could never be written off during the taxable year in which they became worthless, and no deduction could be taken. On the other hand, if banks that used the reserve method were allowed to include these loans in their loan base, they would obtain a tax deduction based in part on this same type of loan. Although it is apparent that there are tax advantages in using the reserve method,[65] it is unlikely that the IRS intended such disparate treatment of similarly situated taxpayers.

This distinct risk criterion has been supported by a number of courts. The Sixth Circuit was the only circuit court to address specifically the risk element of loans includable by banks in their loan base prior to *First National Bank.* In *Akron National Bank & Trust Co. v. United States,*[66] the Sixth Circuit considered a situation in which a bank held undisbursed funds from a construction loan. The bank made disbursements only upon the presentation of invoices from material men and contractors and retained the prerogative to inspect and approve or reject the work or materials. The Sixth Circuit ruled that the loans could not be included in the loan base to the extent of the "hold-back" accounts. The court reasoned that because the hold-back accounts effectively eliminated any element of risk from the loans, the accounts were actually equivalent to cash collateral. The lack of risk therefore qualified the loans for exclusion.

The same circuit later affirmed a Tennessee district court's treatment of the risk issue without additional discussion in *First American National Bank v. United States.*[67] In a thorough discussion of the risk question, the district court had required the exclusion from the loan base of certain loans made by the bank specifically because they involved no risk of loss. The court stated, "Basically as an accounting and business principle, there can be no bad debt if there is no risk of loss."[68] If there can be no loss, reasoned the court, there can legitimately be no reserve maintained to cover that loss.

In *First Wisconsin Bankshares Corp. v. United States,*[69] a Wisconsin district

63 FINNEY & MILLER, PRINCIPLES OF ACCOUNTING 207 (1958).
64 I.R.C. § 166(c).
65 *See* note 13 *supra.*
66 510 F.2d 1157 (6th Cir. 1975). This case was cited by the Seventh Circuit in *First National Bank* in another context.
67 327 F. Supp. 675 (M.D. Tenn. 1971), *aff'd,* 467 F.2d 1098 (6th Cir. 1972).
68 *Id.* at 682.
69 369 F. Supp. 1034 (E.D. Wis. 1973).

court interpreted the § 8 government insured and guaranteed loans exclusion of Revenue Ruling 68-630. The court held that these loans were excluded because they were "loans on which the bank suffers no risk of loss" and thus "cannot be included in the computation of reserves for bad debts."[70] In concluding that the determinative factor was risk, the court ruled that certain loans by First Wisconsin should be eliminated from the loan base because their risk element was comparable to that of government insured or guaranteed loans.

Two final cases that addressed the risk test issue reached conclusions apparently contradictory to those discussed above. In *State Bank of Albany v. United States,*[71] the Court of Claims held that the term "Government Insured Loans" should be given its plain meaning, that is, the exclusion of state and local government loans. If federally insured loans are excludable because of their no-risk nature, it appears that state and municipally insured loans also are risk-free and should be similarly excluded. Therefore, on first examination the limiting interpretation of § 8 loans would support the bank's argument that the loans listed in §§ 3 through 8 simply represent a list of specific loans excludable on the basis of their nonrepresentative nature. In reaching its decision in *State Bank of Albany,* however, the Court of Claims found that state and municipally insured loans actually did not have the same risk-free quality as federally insured loans and were therefore includable in the loan base. Exclusion again depended upon risk.

An Iowa district court in *First Trust & Savings Bank v. United States*[72] also apparently permitted the inclusion of risk-free loans in the bank's loan base. The loans involved special construction financing arrangements with a bank customer on which the bank had never experienced loss. Nevertheless, the court reasoned that the fact that the bank had never suffered a loss in connection with the arrangements did not justify the conclusion that no reasonable risk of loss existed. According to the court, the relevant test was not whether losses had occurred, but whether risk of loss existed.

In addition to the risk criterion, a second criterion for exclusion from the loan base relates to § 5 transactions. As originally set out in Mimeo. 6209, an item that had never been included in income was excludable from the loan base.[73] Inclusion of such items would allow a deduction against taxable income based partially on items that were never subject to taxation. In other words, not only would there be no tax liability on the § 5 unearned discount or interest receivable items in the first instance, but income subject to taxation could be reduced by these same non-taxable items. Obviously, the IRS would want to limit such a double advantage to the taxpayer in reducing tax liability.

By reasoning similar to that involved in the risk criterion analysis, exclusion of § 5 transactions on the basis that bad debt reserves may not be based on an item that has never been included in income would be far more compelling than

70 *Id.*
71 530 F.2d 1379 (Ct. Cl. 1976). This case also was cited by the Seventh Circuit in *First National Bank* in another context.
72 301 F. Supp. 194 (S.D. Iowa 1969).
73 Mimeo. 6209, 1947-2 Cum. Bull. 26.

exclusion on the basis that they represent investment rather than loan activity. This conclusion is especially compelling when transactions of the type described in § 5 are contrasted with the transactions set out in §§ 3, 7 and 8, the true investment activities.

A summary of the analysis of §§ 3 through 8 of Revenue Ruling 68-630 indicates that interbank deposits and loans (§ 3), investments in debt securities (§ 7,) and money market investments (§ 8) could clearly be excluded from the loan base on the grounds that they represent the bank's investment activity and, as such, are not "representative of the bank's ordinary portfolio of outstanding customer loans."[74] Unearned discount or interest receivable (§ 5) may also be eliminated on the basis that it represents investment rather than loan activity. However, the fact that the discount or interest receivable has never been included in income and therefore cannot be included in computing a deduction from income, provides a more convincing argument for these items' exclusion. Cash collateral loans (§ 4) and government insured or guaranteed loans (§ 6) are clearly excludable under the risk analysis. Loans upon which there can be no loss should not be included in the loan base for computing reserves to cover losses on bad debts. Contrary to First National Bank's argument, Revenue Ruling 68-630 does not merely exclude loans that are not "representative of the bank's ordinary portfolio of outstanding customer loans,"[75] as summarized by that language in § 9. Rather, Revenue Ruling 68-630 excludes loans of three distinct types in §§ 3 through 8: loans more closely aligned with the investment activity of the bank than with its loan activity; risk-free loans; and transactions not included in income. In addition to these categories, § 9 excludes a fourth type of loan defined as loans "not representative of the bank's ordinary portfolio of outstanding customer loans."[76] In light of this analysis, the Seventh Circuit correctly determined that § 9 provided an independent basis for exclusion.

VII. Applying the Representativeness Criterion

Although the Seventh Circuit reversed the Tax Court by holding that § 9 was an independent basis for exclusion, the court did adopt a portion of the Tax Court's decision in *First National Bank*. The Seventh Circuit agreed that the loans to the Trust Department by the Commercial Loan Department did not come under the exclusions in §§ 3 through 8.[77] The only remaining issue on appeal was whether the loans were not representative of the ordinary customer loan activity of the bank and thus excludable under § 9.

The court was required to consider this issue in light of the principle that only those additions to bad debt reserves that are allowed in the reasonable discretion of the Secretary of the Treasury are permitted deductible additions.[78]

74 Rev. Rul. 630, § 9, 1968-1 Cum. Bull. 84.
75 *Id.*
76 *Id.*
77 64 T.C. 1001 (1975).
78 I.R.C. § 166(c). Simply electing to use the bad debt reserve method subjects the taxpayer to the discretion of the Secretary. Union National Bank & Trust Co. of Elgin, 26 T.C. 537 (1956); S.W. Coe & Co. v. Dallman, 216 F.2d 566 (7th Cir. 1954).

This firmly established principle[79] places a heavy burden on the taxpayer to demonstrate abuse of discretion by the Secretary. The court thus proceeded on the assumption that the addition to the reserve for bad debts was reasonably excluded. The burden then shifted to First National to demonstrate that the Commissioner's exclusion was an abuse of that discretion. The Seventh Circuit recognized that the crucial question under § 166(c) and Revenue Ruling 68-630 is whether the Commissioner's rather than the taxpayer's view of the challenged addition is reasonable. Where both are found to be reasonable, the Commissioner's determination prevails.[80]

Against this background of a presumption of reasonableness on the part of the Commissioner, the court considered the nature of the loans at issue in light of § 9. The court determined that the loans were not representative of ordinary customer loan activity and cited a number of factors in support of this conclusion. For example, the Commercial Loan Department received no notes for the overdrafts, neither maturity dates nor repayment schedules were imposed, and interest was not charged. None of the advances had ever been written off as uncollectible. The bank's commercial loan officers did not consider or evaluate the loans, nor did the trust officers authorize advances unless they were certain that the trust had sufficient incoming funds to repay them. Furthermore, the parties stipulated that the bank experienced only nominal or *de minimus* losses.[81] These facts clearly undermine any argument that the loans were representative. The Trust Department loans were not comparable to ordinary customer loan activities in terms of either form or procedure. The typical customer loan requires application and approval by the bank's loan officers. Interest, a primary purpose for making loans from the bank's point of view, is charged. The transactions between First National's Trust Department and its Commercial Loan Department more closely resembled interdepartmental bookkeeping and accounting procedures than loan activity "representative of the bank's ordinary portfolio of outstanding customer loans."[82]

In addition to concluding that the Trust Department advances were nonrepresentative, the court also found that the bank had clearly failed to meet its burden of demonstrating abuse of discretion by the Secretary. First National attempted to demonstrate that even if the loans were excludable under § 9, its inclusion of the Trust Department loans was reasonable on several bases. First, the bank showed that the transactions were carried as loans for financial statement purposes. Furthermore, the bank argued that because it had no cash collateral directly under its control, the loans were includable under § 4 despite the

79 This position has been well established by case law. Akron National Bank & Trust Co. v. United States, 510 F.2d 1157 (6th Cir. 1975); Atlantic Discount Company, Inc. v. United States, 473 F.2d 412 (5th Cir. 1973); Merchants Industrial Bank v. Commissioner, 475 F.2d 1063 (10th Cir. 1973); Dixie Furniture Co. v. Commissioner, 390 F.2d 139 (8th Cir. 1968); Calavo, Inc. v. Commissioner, 304 F.2d 650 (9th Cir. 1962); Paramount Finance Co. v. United States, 304 F.2d 460 (Ct. Cl. 1962); American State Bank v. United States, 279 F.2d 585 (7th Cir. 1960); S. W. Coe & Co. v. Dallman, 216 F.2d 566 (7th Cir. 1954).

80 Akron National Bank & Trust Co. v. United States, 510 F.2d 1157 (6th Cir. 1975); First Commercial Bank, 45 T.C. 175 (1965); Ehlen v. United States, 323 F.2d 535 (Ct. Cl. 1963); Paramount Finance Co. v. United States, 304 F.2d 460 (Ct. Cl. 1962).

81 546 F.2d at 759 (7th Cir. 1976).

82 Rev. Rul. 630, § 9, 1968-1 Cum. Bull. 84.

fact that no losses were anticipated. Finally, the bank argued that the transactions in effect represented overdrafts on deposit accounts which were includable in the loan base under § 4. None of these arguments were persuasive, but even if the bank had been able to demonstrate a reasonable basis for including the loans, such a showing would have been insufficient. As the Court of Claims has noted, "It does not follow that if the plaintiff (taxpayer) was reasonable in its determination, the defendant (Commissioner) was unreasonable."[83] Furthermore, the Seventh Circuit's determination that the loans at issue were excludable from the loan base under § 9 because, among other factors, they were risk-free, non-interest bearing and non-representative of ordinary customer loan activity, further supports the conclusion that the Commissioner reasonably exercised his discretion in disallowing the addition. As the Seventh Circuit correctly observed, whenever reserve additions are disallowed, the court's inquiry must focus on the Commissioner's exercise of his discretion rather than on whether there may have been some reasonable basis for the taxpayer's actions.

Under either the discretion test or the representativeness test, therefore, the Seventh Circuit reached a decision that was clearly consistent with the purpose and intent of the bad debt reserve and Revenue Ruling 68-630.

VIII. Conclusion—The Trend in the Tax Law

Although Revenue Ruling 68-630 has been superceded for the tax year beginning July 11, 1969, the impact of the Seventh Circuit's decision in *First National Bank v. Commissioner* is significant. The law and principles under which the case was decided are even more viable in light of the new tax laws. The uniform reserve ratio theory has been enacted into law as § 585 of the Code,[84] and the criteria set out in Revenue Ruling 68-630 have been incorporated into proposed Treasury Regulations.[85]

The Depression generated concern with respect to commercial banks' ability to survive a future period of catastrophic losses. As a result, banks have been permitted to accumulate a reserve for bad debts in excess of the amounts generally permitted other taxpayers, as a cushion against periods of high losses in times of economic recession or depression. This policy was first effected by allowing banks to employ any twenty-year period after 1927 to compute the ratio of bad debt losses to outstanding loans, which allowed the inclusion of high-loss Depression years in the ratio.[86] With the passage of time, however, it became increasingly difficult in light of existing economic conditions to justify inclusion of Depression years in the computation. The policy of preferential treatment for banks was then implemented by establishing a uniform reserve ratio of 2.4%, a ratio higher than most banks could achieve on the basis of experience in current years.

As the Depression experience becomes more historically remote, the zeal for tax reform has increased and insistence on equal treatment for similarly situated

83 Paramount Finance Company v. United States, 304 F.2d 460, 464 (Ct. Cl. 1962).
84 I.R.C. § 585.
85 Proposed Treas. Reg. § 585-2(e)(3)(i), 41 Fed. Reg. 40482 (1976).
86 Mimeo. 6209, 1947-2 Cum. Bull. 26; Rev. Rul. 148, 1954-1 Cum. Bull. 69.

taxpayers has become stronger. As a result of these and other factors, Congress enacted § 585 of the Internal Revenue Code. Although § 585 incorporates the uniform reserve ratio theory for computation of reserves for bad debts, as originally set out in Revenue Ruling 65-92, it has significantly reduced the actual ratio and eventually eliminates the use of the uniform reserve ratio altogether.[87] After 1987, banks will be allowed to compute their reserves on an experience basis only, as do non-bank taxpayers. As one commentator has noted, the net effect of the scheduled reductions in the ratio is substantial:

> When one considers that a 50% increase in loans will be necessary to absorb the reduction in the reserve percentage from 1.8 to 1.2% and an additional 100 percent increase to absorb the reduction from 1.2 to .6 percent (to say nothing of the reduction from .6 percent to actual experience), it is obvious that banks are facing a long dry spell insofar as reserve additions are concerned.[88]

As a result of this downward adjustment in the allowable reserve ratio, banks will be anxious to maximize the amount of allowable inclusions in the loan base to which the ratio is applied. These inclusions remain the only flexible factor in the formula. Therefore, banks will attempt to include more loans that may only be marginally eligible. On the other hand, the IRS, seeking to implement current tax policy, can be expected to disallow more and more questionable inclusions. This conflict is likely to produce increased litigation under the current law on the issue that confronted the Seventh Circuit in *First National Bank,* at least until reserve ratio computations stabilize under the experience method after 1987. It will be necessary for the courts to interpret guidelines promulgated by the IRS with respect to eligible loans. Section 585(b)(4)[89] defines the term "loans" to which the ratio (experience factor after 1987) applies. As previously noted, the loans set out include each of the types of loans previously set out in Revenue Ruling 68-630. Section 585(b)(4) further provides that "[t]he Secretary shall define the term 'loan' and 'eligible loan' and prescribe regulations as may be

87 I.R.C. § 585 ultimately disallows use of the uniform reserve ratio altogether. During transitional years, the allowable ratio will be reduced according to the following schedule:

For taxable years beginning after	but before	Allowable %
July 10, 1969	1976	1.8%
1975	1982	1.2
1981	1988	0.6
1987	.....	Method not Allowed

88 Sachs, *Bad Debt Reserves of Commercial Banks,* 92 BANKING LAW JOURNAL 930 (1975).

89 I.R.C. § 585(b)(4) provides:

> [T]he term "eligible loan" shall not include —
> (A) a loan to a bank (as defined in section 581),
> (B) a loan to a domestic branch of a foreign corporation to which subsection (a)(2) applied,
> (C) a loan secured by a deposit (i) in the lending bank, or (ii) in an institution described in subparagraph (A) or (B) if the lending bank has control over withdrawal of such deposit,
> (D) a loan to or guaranteed by the United States, a possession or instrumentality thereof,
> (E) a loan evidenced by a security as defined in section 165(g)(2)(C),
> (F) a loan of Federal funds, and
> (G) commercial paper, including short-term promissory notes which may be purchased on the open market.

necessary to carry out the purposes of this section."[90] The proposed regulations[91] that explain and expand eligible loans and the basis for their exclusion are subject to the same problems of interpretation that confronted the Seventh Circuit Court in *First National Bank*. Further, the proposed regulations have specifically included the representativeness criterion by defining eligible loans as only those loans "incurred in the course of the normal customer loan activities of a financial institution . . .",[92] language similar in meaning and intent to the language set out in § 9 of Revenue Ruling 68-630. Thus, every issue considered in *First National Bank* remains viable under the current tax law. The basic question—determination of what constitutes an eligible loan—becomes more critical as banks attempt to enlarge their loan base in order to continue to make deductible additions to their reserve for bad debts. The Seventh Circuit has set a precedent in *First National Bank v. Commissioner* which will assume increasing importance in the future.

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90 I.R.C. § 585(b)(4).
91 Proposed Treas. Reg. § 1.585, 41 Fed. Reg. 40482 (1976).
92 *Id.*

FEDERAL TAXATION—WITHHOLDING PROVISIONS—EMPLOYERS ARE REQUIRED TO WITHHOLD INCOME TAXES FROM MEAL REIMBURSEMENTS GIVEN TO EMPLOYEES ON NON-OVERNIGHT TRIPS.

*Central Illinois Public Service Co. v. United States**

I. Introduction

Section 3402(a) of the Internal Revenue Code requires employers to withhold from wages a tax determined in accordance with tables prescribed by the Secretary of the Treasury.[1] In *Central Illinois Public Service Co. v. United States*, the United States Court of Appeals for the Seventh Circuit confronted the issue of whether payments made by an employer to reimburse its employees for lunches eaten on non-overnight business trips constituted wages subject to federal income tax withholding provisions.[2]

The issue bears special significance not only for the government but for employers as well. If meal reimbursements are deemed wages but an employer fails to withhold the prescribed tax, the employer is liable for the amount of the tax that should have been withheld.[3] If the reimbursements are not deemed wages, employees must nevertheless include them as income and pay any income taxes owed on these non-wage reimbursements. From the government's viewpoint, however, the latter situation poses difficulties. Lunch reimbursements paid an individual employee are usually not large enough to merit an audit of the employee's tax return to determine if they have been declared as income. Consequently, it is difficult for the government to ascertain whether an employee has included lunch reimbursements in his tax return. Yet in the aggregate, employees' failure to include lunch reimbursements in their tax returns could result in the loss of substantial tax revenue.[4] It is evident, therefore, that employers are concerned with the implications of this issue for potential tax liability, and the government is concerned with the issue's implications for potential tax evasion.

The question faced by the Seventh Circuit in *Central Illinois* had been addressed three years earlier by the Fourth Circuit in *Royster Co. v. United States*.[5]

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* 540 F.2d 300 (7th Cir. 1976), *cert. granted*, 431 U.S. 903 (1977).

1 I.R.C. § 3402 (a).

2 The relevant provisions of the Internal Revenue Code of 1954 are:

I.R.C. § 3401. Definitions.

(a) Wages.

For purposes of this chapter, the term "wages" means all remuneration . . . for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash . . . .

I.R.C. § 3402. Income tax collected at source.

(a) Requirement of withholding.

Except as other wise provided in this section, every employer making payment of wages shall deduct and withhold upon such wages a tax determined in accordance with tables prescribed by the Secretary. . . .

I.R.C. § 3403. Liability for tax.

The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment.

3 I.R.C. § 3403.

4 In *Central Illinois*, for example, lunch reimbursements for non-overnight trips totaled $139,936.12. The tax owed on this amount was $36,615.72 (including interest).

5 479 F.2d 387 (4th Cir. 1973).

In *Royster* the Fourth Circuit held that reimbursements paid to salesmen for the cost of lunches eaten in their sales territories were not "wages" for withholding purposes. The Fourth Circuit noted that the Code defined wages as "remuneration for services."[6] Because the salesmen "performed no services while eating, directly or indirectly," the court concluded that the payments were not remuneration for services.[7] Accordingly, the Fourth Circuit held that the reimbursements were not wages and therefore not subject to withholding.[8]

Both the government and the Seventh Circuit recognized that, on its facts, *Central Illinois* was not meaningfully distinguishable from *Royster*. The Seventh Circuit, however, disagreed with the reasoning employed in *Royster*. The Seventh Circuit found the Fourth Circuit's definition of "wages" too narrow. The Seventh Circuit concluded that lunch reimbursements are part of a "total package of remuneration"[9] and, as such, must be considered wages. As a result, in direct contravention of the Fourth Circuit's holding, the Seventh Circuit held that an employer is liable for withholding tax on lunch reimbursements provided to employees on non-overnight business trips.[10]

This comment analyzes the holding in *Central Illinois* in light of interpretations given the withholding provisions of the Code by the courts and the Internal Revenue Service and considers the holding in light of the realities of income tax collection. The Seventh Circuit's conclusion that the lunch reimbursements in question are subject to withholding tax is supported by the clear weight of both judicial and IRS decisions. Just as importantly, the Seventh Circuit's holding is the correct position with respect to the practical considerations related to the collection of income tax.

II. Statement of the Case

Central Illinois Public Service Company (the company) is an Illinois corporation with its principal office in Springfield, Illinois. It is a regulated public utility that supplies electricity and natural gas to an extensive area of downstate Illinois.[11]

To service this area, the company often sends employees away from their home bases, both for day trips during normal working hours and for overnight trips. The company had a long-established policy of reimbursing its employees for legitimate expenses of transportation, meals, and lodging incurred when travelling on company business. In this case, only lunch reimbursements made to employees away from their regular duty areas on non-overnight trips were at issue.[12]

The amount of the lunch reimbursement depended on the status of the employee. Unionized employees and operating employees of the Western division received a flat reimbursement of $1.40 per lunch, regardless of the amount

6 *Id.* at 390.
7 *Id.* at 391.
8 *Id.* at 392.
9 540 F.2d at 303.
10 *Id.*
11 *Id.* at 300.
12 *Id.*

actually spent.[13] In contrast, salaried employees received a reimbursement equal to their actual expenditure, up to a $25 per meal limit.[14]

In 1963, the tax year in question, the company paid its employees $139,936.12 as reimbursements for lunches eaten on non-overnight trips but failed to withhold income taxes with respect to this sum. Consequently, in 1971 the District Director of the IRS assessed a deficiency against the company for additional withholding taxes totalling $36,615.72, including interest.[15] The company paid this sum and sued for a refund.

The United States District Court for the Southern District of Illinois,[16] in an opinion that relied on *Royster,* held that the reimbursements in question were not wages because they were not remuneration for services rendered. Therefore, according to the court, they were not subject to income tax withholding. The government appealed this decision to the Seventh Circuit.

On appeal, the Seventh Circuit reversed the district court. As previously stated, the Seventh Circuit viewed the holding in *Royster* as an overly narrow interpretation of the term "wages" and held that the reimbursements in question were indeed wages subject to the withholding of income tax.[17]

III. Withholding Taxes

The determination that a payment is a wage typically results in the imposition of three distinct taxes:[18] Federal Insurance Contribution Act (F.I.C.A.) taxes,[19] Federal Unemployment Act (F.U.T.A.) taxes,[20] and employees' withheld income taxes.[21]

F.I.C.A. taxes are levied upon both employer and employee. These taxes defray the cost of social security programs that provide benefits to the retired and disabled and their dependents.[22] The employer acts not only as a collection agent for the government by withholding F.I.C.A. taxes from each employee's wages, but the employer must also contribute to the F.I.C.A. tax fund by matching the F.I.C.A. payments made by each employee. The payments are based upon rates established by Congress; there is a maximum wage base, however, beyond which no F.I.C.A. taxes are imposed on either employer or employee.[23]

Unlike F.I.C.A. taxes, only the employer pays F.U.T.A. taxes. These taxes are used to provide relief funds for the unemployed. As with F.I.C.A. taxes, F.U.T.A. tax rates are established by Congress and are subject to a maximum wage base.[24]

In contrast to F.I.C.A. and F.U.T.A. taxes, employees' withheld income

13 *Id.* at 301.
14 *Id.*
15 *Id.*
16 405 F. Supp. 748 (S.D. Ill. 1975).
17 *Id.* at 303.
18 Brief for Appellant at 10, Central Illinois Public Service Co. v. United States. Not all wage payments are subject to these taxes because certain payments are exempt. *See* I.R.C. § 3401(a) 1-16.
19 I.R.C. §§ 3111-26.
20 I.R.C. §§ 3301-11.
21 I.R.C. §§ 3401-04.
22 S.S. Kresge v. United States, 218 F. Supp. 240, 243 (E.D. Mich. 1963).
23 I.R.C. § 3101. In 1963 the maximum wage base for F.I.C.A. taxes was $4,800.
24 I.R.C. § 3301. In 1963 the maximum wage base for F.U.T.A. taxes was $3,000.

taxes are paid entirely by the employee. The purpose of these taxes is twofold. First, they effect periodic payments of an employee's income tax during the course of the year rather than a lump sum payment at the end of the tax year. Second, they ensure a prompt and certain flow of revenue to the Treasury.[25] An integrated system of withholding and estimates is used to achieve these goals. Ideally, the system leaves no tax payable when an employee files his tax return. In practice, however, this pay-as-you-go system invariably requires an additional payment or refund.[26] No maximum wage base exists for the imposition of this tax.

Each of the foregoing taxes is imposed upon "wages." Although there are slight variations in each tax's definition of "wages," the differences are inconsequential;[27] each tax applies essentially the same meaning to the term. This basic definition encompasses all remuneration for services.[28] Nonetheless, there are times when an employer is not required to withhold employee income taxes from wages but must still withhold employee F.I.C.A. taxes and pay employer F.I.C.A. and F.U.T.A. taxes.[29] As the Ninth Circuit noted in *Pacific American Fisheries v. United States*:

> The presumption that income tax and social security tax [F.I.C.A. and F.U.T.A. taxes] are taxes of the same nature . . . is not so. Income taxes are revenue, levied to defray the expenses of the government. The Social Security Act . . . provides for old age security, unemployment insurance, security for child dependents, etc. It expressly was enacted for the benefit of the payee of wages. It is possible that what might not be taxable income for income tax purposes might constitute wages under the provisions of the Social Security Act.[30]

Although some wage payments subject to F.I.C.A. and F.U.T.A. taxes are not subject to income tax withholding, all wage payments subject to income tax withholding are subject to F.I.C.A. and F.U.T.A. taxes, unless, of course, the wage payment goes beyond the maximum wage ceiling for F.I.C.A. and F.U.T.A. taxes.

Thus, with respect to employee F.I.C.A. and employee income taxes, employers act as collection agents for the government. Employer liability results

25 *See* 89 CONG. REC. 4571 (1943) (Statement of Randolph E. Paul, General Counsel for the Treasury).

26 5 Rabkin & Johnson, Federal Income, Gift, and Estate Taxation § 74.01.

27 The income tax withholding provision defines "wages" as: "all remuneration . . . for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash." I.R.C. § 3401. The F.U.T.A. and the F.I.C.A. tax provisions define "wages" as: "all remuneration for employment, including the cash value of all remuneration paid in any medium other than cash." I.R.C. § 3121(a), I.R.C. § 3306(b).

28 The Fourth Circuit reached this conclusion in *Royster*, 479 F.2d at 390.

29 For instance, Congress has created a specific exception for income tax withholding for meals furnished pursuant to I.R.C. § 119. The value of these meals is not, however, exempt from F.U.T.A. and F.I.C.A. payments. *See* S.S. Kresge v. United States, 218 F. Supp. 240 (E.D. Mich. 1963).

30 138 F.2d 464, 465 (9th Cir. 1943). *See also* Southern Pac. Co. v. Joint Council of Dining Car Employees, 165 F.2d 26 (9th Cir. 1947), *cert. denied*, 333 U.S. 838 (1948); S.S. Kresge v. United States, 218 F. Supp. 240; Rev. Rul. 71-411, 1971-2 Cum. Bull. 103; Rev. Rul. 65-194, 1965-2 Cum. Bull. 382.

only when employers neglect to withhold these taxes.[31] For F.U.T.A. and employer F.I.C.A. taxes, on the other hand, employers are tax payers as well as tax collectors.

In *Central Illinois* only the withholding of employee income taxes was at issue. Although it is not clear from the Seventh Circuit's opinion, it appears that F.I.C.A. and F.U.T.A. taxes were not involved because the IRS determined that the vast majority of Central Illinois employees who received lunch reimbursements made more than the maximum wage ceiling applied to these taxes.[32] It seems, therefore, that no additional deficiency was asserted because the IRS realized that additional F.I.C.A. and F.U.T.A. taxes were not required irrespective of whether the meal payments were "wages." It is noteworthy, however, that if the reimbursements in question in *Central Illinois* are subject to income tax withholding, employers who provide similar reimbursements to employees with earnings less than the maximum wage ceiling must withhold employee F.I.C.A. taxes and pay employer F.I.C.A. and F.U.T.A. taxes in addition to withholding employee income tax.[33] Thus, besides additional withholding responsibilities, these employers would also face additional tax liability.

IV. Wages and Income

A. *Meal Reimbursements as Income*

With the previous section as background, it is now possible to focus attention on the meal reimbursements in *Central Illinois* from the viewpoint of the federal withholding tax provisions.

Treasury Regulation § 31.3401(a)-1(b)(9) states: "The value of any meals . . . furnished to an employee by an employer is not subject to withholding if the value of the meals . . . is excludable from the gross income of the employee."[34] Accordingly, the threshold question in *Central Illinois* was whether the reimbursements in question were includable in the employees' gross income.

The Supreme Court has consistently given great latitude to the term "gross income" in an effort "to tax all gains except those specifically exempted."[35] In *Commissioner v. Smith*,[36] the Supreme Court stated that the term gross income as defined by the Code "is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected."

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31 For failure to withhold income taxes, I.R.C. § 3403 provides: "The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of such payment." For failure to withhold F.I.C.A. taxes, I.R.C. § 3102(b) provides: "Every employer required so to deduct the tax shall be liable for the payment of such tax, and shall be indemnified against the claims and demands of any person for the amount of any such payment made by such employer."

32 Brief for Appellant at 10 n.4, Central Illinois v. United States.

33 In *Royster*, for example, in addition to withholding, F.I.C.A. and F.U.T.A. tax payments were also in issue.

34 Treas. Reg. § 31.3401(a)-1(b)(9). *See also* Rev. Rul. 593, 1954-2 C. B. 31.

35 Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 430 (1955). *See also* Ritter v. United States, 393 F.2d 823 (Ct. Cl. 1968).

36 324 U.S. 177, 181 (1945). In Comm'r. v. LoBue, 351 U.S. 243 (1956), the Supreme Court reiterated this position. There it held that as long as an economic benefit is conferred upon an employee for the purpose of securing better services, then the employee has realized taxable income. *See also* Treas. Reg. § 1.162-17.

Clearly, a meal reimbursement is an economic benefit that qualifies as part of an employee's gross income.[37] Although the Seventh Circuit did not specifically address the issue, certain meal reimbursements are excludable from income pursuant to § 119 of the Code. Section 119 excludes from income the value of any meal furnished to an employee by his employer for the convenience of the employer and on the business premises of the employer.[38]

At first, it might appear that the lunch reimbursements in *Central Illinois* were not excludable under I.R.C. § 119 because the meals were neither *furnished* by the employer nor eaten on the business premises. Nevertheless, a line of cases involving meal reimbursements provided to state highway patrolmen holds that *reimbursements* as well as the value of meals actually furnished by an employer are subject to exclusion if the "convenience of the employer" and "business premises" tests are met. Moreover, this same line of cases recognizes that the "business premises of the employer" can encompass an area larger than the employer's actual headquarters. Although there is a sharp split among the circuits, some hold meal reimbursements excludable from income even when the meals are taken at public restaurants.[39]

Arguably, the position of the Central Illinois employees who must maintain equipment throughout an extensive service area does not differ materially from that of state highway patrolmen who must patrol away from their headquarters and take meals on the road. Hence, the highway patrolmen cases provide support for the contention that the reimbursements at issue in *Central Illinois* were excludable from the employees' gross income under § 119 of the Code.

Yet even if meal reimbursements are accepted as tantamount to furnishing meals, and even if the business premises concept is expanded to encompass employees who work away from headquarters, the "convenience of the employer

37 An alternative treatment of the reimbursement would be to classify it as a gift. In the statutory sense, however, a gift must arise from "detached and disinterested generosity," Comm'r. v. LoBue, *supra* note 36 at 246, or "out of affection, respect, admiration, charity or like impulse," Robertson v. United States, 343 U.S. 711, 714 (1952). Obviously, this is not a proper assessment of the reimbursements in question in *Central Illinois*.

38 I.R.C. § 119 states in full:

> There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him by his employer for the convenience of the employer, but only if—
>
> (1) in the case of meals, the meals are furnished on the business premises of the employer, or
>
> (2) in the case of lodging, the employee is required to accept such lodging on the business premises of his employer as a condition of employment.
>
> In determining whether meals or lodging are furnished for the convenience of the employer, the provisions of an employment contract or of a state statute fixing terms of employment shall not be determinative of whether the meals or lodging are intended as compensation.

39 *See* Comm'r. v. Kowalski, 544 F.2d 686 (3d Cir. 1976) *cert. granted,* 430 U.S. 944 (1977); United States v. Keeton, 383 F.2d 429 (10th Cir. 1967); United States v. Morelan, 356 F.2d 199 (8th Cir. 1966); United States v. Barrett, 321 F.2d 911 (5th Cir. 1963); Saunders v. Comm'r., 215 F.2d 768 (3d. Cir. 1954). *Contra* Wilson v. United States, 412 F.2d 694 (1st Cir. 1969); Rev. Rul. 85, 1970-1 C.B. 214. The Third Circuit has held that "furnishing meals" also includes furnishing groceries, paper goods, and related products. Jacob v. United States, 493 F.2d 1294 (3d Cir. 1974).

[Note: Subsequent to this comment's completion, the Supreme Court decided *Kowalski* (46 U.S.L.W. 4015 (1977)). The Court held that cash meal allowances provided to state troopers are includable in gross income and that § 119 covers only *meals* furnished by the employer, not *cash* reimbursements. This removes any doubt as to whether the reimbursements in question are income.]

test" must be met before a § 119 exclusion is permissible. To meet this third standard, the meal must be furnished as a means of enabling the employee to be available for emergency call during his meal period, to comply with a short meal period, or because there are insufficient eating facilities in the vicinity of the employer's premises to enable an employee to return to work within a reasonable period of time.[40] There is no indication in *Central Illinois* that the reimbursements met this standard. Although employees were always subject to call, they were off duty during their lunch period.[41] The meal was not furnished to allow employees to remain on call. Therefore, § 119 is not authority for excluding the reimbursements from income.

Thus, even if the Seventh Circuit were to give an expansive interpretation to the furnishing of meals and business premises concepts, the reimbursements in *Central Illinois* would still fall outside the ambit of I.R.C. § 119 because they fail the "convenience of the employer" test. As a result, the reimbursements in question must be treated as income to employees includable in their tax returns.

B. *Income Distinguished From Wages*

Having established that the lunch reimbursements in *Central Illinois* were includable in the employees' gross income, it might appear that the reimbursements must also be treated as wages. As previously noted, Treasury Regulation 31.3401(a)1-(b)(9) provides that meal reimbursements excludable from income need not be treated as wages. It is thus logical to assume that meal reimbursements includable in income should be treated as wages. The government takes this stance in Revenue Ruling 71-411, which provides:

> Accordingly, if the value of meals furnished employees by their employer is excludable from the gross income of the employees under section 119 of the Code, it is not subject to the withholding of income tax. Conversely, if the value of such meals is not excludable from the gross income of the employees, it is "wages" subject to the withholding of income tax under section 3402 of the Code.[42]

Although the above argument appears reasonable, the revenue rulings and court decisions presented below demonstrate that a payment from an employer to an employee may constitute gross income to the employee yet not be wages subject to withholding. Therefore, an inquiry into whether the lunch reimbursements in *Central Illinois* were wages cannot end with the determination that the reimbursements constituted gross income to the employees.

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40 Treas. Reg. § 119-1(a)2(ii)(a)-(c). *See also* Rev. Rul. 411, 1971-2 C.B. 103. *But cf.* O.D. 514, 2 C. B. 90 (1920), which states:

> "Supper money" paid by an employer to an employee, who voluntarily performs extra labor for his employer after regular business hours, such payment not being considered additional compensation and not being charged to the salary account, is considered as being paid for the convenience of the employer and for that reason does not represent taxable income to the employee.

It seems possible to rely on this provision as support for the argument that the convenience of the employer test was met in *Central Illinois.* A distinguishing feature of *Central Illinois,* however, is that the Central Illinois employees were not performing any extra work for their employer; rather, they were performing their usual day's work, albeit at a location different from their normal place of work.

41 405 F. Supp. at 799.

42 Rev. Rul. 411, 1971-2 C. B. 103, 105.

1. Revenue Rulings

Revenue Ruling 55-520 was one of the first rulings to hold that a payment by an employer to an employee, although includable in the employee's gross income, was not wages. At issue was an amount paid to an employee as a compromise settlement of an employment contract prior to its expiration. The ruling held that although the employee was required to include the payment in gross income for federal income tax purposes, it was not a payment for services performed and therefore not wages.[43]

A later revenue ruling held that a lump sum payment received by a railroad employee in consideration of relinquishing seniority rights and terminating his employment in a particular position was gross income to the recipient. Nevertheless, the amount was not considered compensation for services and therefore was not subject to the withholding of taxes.[44]

The IRS again emphasized that wages are not merely payments of gross income from an employer, but rather payments for services, in Revenue Ruling 58-145. It was held there that withholding of a bonus paid to a baseball player for signing his first contract is not required when the bonus is not contingent upon the player's performing subsequent services, even though the bonus is clearly gross income.[45]

In Revenue Ruling 72-110, reimbursements for the acquisition and maintenance of uniforms were at issue. The ruling held that the reimbursements were income to the employees. Yet because the allowances were not remuneration for services, they were not considered wages subject to withholding.[46]

In light of the foregoing and other revenue rulings,[47] courts began to look beyond the question of whether a payment constitutes income to determine whether the payment represents wages for withholding purposes.[48] Especially prominent among the cases that have established that employer payments of income to employees are not invariably tantamount to wage payments are the "convention" cases and the "moving expense" cases.

2. Convention Cases

The convention cases are a series of decisions pertaining to the tax treatment of trips to business conventions provided by an employer to his employees. The

43 Rev. Rul. 520, 1955-2 C. B. 393. *See also* Revenue Ruling 58-301, in which it was held that a lump sum payment received by an employee as consideration for the termination of his employment contract was gross income but not wages for withholding purposes. Rev. Rul. 301, 1958-1 C. B. 23. These payments must be distinguished from *dismissal* payments, which are wages for withholding purposes. Rev. Rul. 408, C. B. 1971-2 340; Rev. Rul. 572, C. B. 1972-2 535. *See also* Rev. Rul. 252, C. B. 1974-1 287.

44 Rev. Rul. 227, 1959-2 C. B. 13. This ruling was superseded, however, by Rev. Rul. 44, 1975-1 C. B. 15, in which the IRS stated that the amount received by an employee for relinquishing seniority rights was a lump sum settlement for the past performance of services reflected in the employment rights given up and was therefore remuneration for services. Thus, the payment was held subject to the withholding of income taxes.

45 Rev. Rul. 145, 1958-1 C. B. 360.

46 Rev. Rul. 110, 72-1 C. B. 24.

47 *See also* Rev. Rul. 371, 1959-2 C. B. 236; Rev. Rul. 249, 1956-1 C. B. 488; [Rev. Rul. 190, 1953-2 C. B. 303].

48 Rev. Rul. 269, 1958-1 C. B. 344 recognized that even a payment to a person for the performance of services is not subject to withholding if the person who makes the payment and the recipient are not in an employer-employee relationship when the payment is made.

first issue to surface in these cases was whether convention expense reimbursements were includable as income. *Patterson v. Thomas*[49] and *Rudolph v. United States*[50] held that an employee provided with an all-expense-paid convention trip by an employer was required to treat the entire value of the trip as income. Moreover, the cases held that the employee could not deduct the entire cost of the trip because the total cost was not an ordinary and necessary business expense.[51] The question of whether these payments also constituted wages subject to withholding was not addressed in either of these cases.

In two later cases, both decided in 1967, *People's Life Insurance Co v. United States*[52] and *Acacia Mutual Life Insurance Co. v. United States,*[53] the government attempted to take the issue one step further. In these cases the government claimed that convention expense payments were wages subject to withholding. The government argued that the convention trips amounted to prizes to employees for their sales efforts during the year and, as such, were reimbursements for services subject to withholding.

In *Acacia* as well as *People's Life* the courts rejected the government's argument. Without deciding whether the payments constituted income to the employees, the courts held that the payments were not wages and not subject to withholding.[54]

Although the sole issue in *Acacia* and *People's Life* was whether the expense payments were wages subject to withholding and neither court decided whether the payments were income to the employees, both courts commented on the relationship between gross income and wages. In *People's Life* the court remarked: "There is no necessary correlation between what constitutes 'wages' or 'remuneration' paid by an employer within the meaning of the employment or withholding tax sections, and what constitutes 'income' to the employee within the meaning of 'gross income' sections."[55] The *Acacia* court noted that in determining whether a payment is wages, the purpose of the employer in making the payment controls. By contrast, the court stated that the payment must be analyzed from the employee's point of view to determine whether it constitutes gross income.[56]

Both *Acacia* and *People's Life* were distinguished from *Patterson* and *Rudolph* on the grounds that in the latter cases the conventions were actually

49 289 F.2d 108 (5th Cir. 1961), *cert. denied,* 368 U.S. 837 (1961).

50 189 F. Supp. 2 (N.D. Tex. 1960).

51 In *Patterson,* the taxpayer was allowed a *pro rata* deduction for the amount of time he spent at business meetings. *Rudolph* permitted no deduction. For an excellent discussion regarding the deductibility of convention expenses, *see* Postelwaite, *Deductibility of Expenses for Conventions and Educational Seminars,* 61 MINN. L. REV. 253 (1977).

52 373 F.2d 924 (Ct. Cl. 1967).

53 272 F. Supp. 188 (D. Md. 1967).

54 Both courts concluded that the payments were not considered wages pursuant to Treas. Reg. § 31.3401(a)-1(b)(2), which states: "Amounts paid specifically—either as advances or reimbursements—for traveling or other bona fide ordinary and necessary expenses incurred or reasonably expected to be incurred in the business of the employer are not wages and not subject to withholding;" and Treas. Reg. § 31.3401(a)-1(b)(10), which states: "Ordinarily, facilities or privileges . . . furnished or offered by an employer to his employees generally, are not considered as wages subject to withholding if such facilities or privileges are of relatively small value and are offered or furnished by the employer merely as a means of promoting the health, good will, contentment, or efficiency of his employees."

55 373 F.2d at 932. *See also* note 47 *supra,* and rulings cited therein.

56 272 F. Supp. at 195.

pleasure trips. The conventions in the former cases, on the other hand, were bona fide business trips. Based on the clear-cut distinctions drawn between the two groups of cases, it could be inferred that, had the issue arisen, the *Acacia* and *People's Life* courts would not have held that the convention expense payments were income to the employees. Nevertheless, it remains apparent in both *People's Life* and *Acacia* that even if the courts had concluded that the payments were income to the employees, the courts would not necessarily have labelled the payments wages.

3. Moving Expense Cases

Relying to a large extent on the "convention" cases, three cases in which reimbursements for moving expenses were at issue made it unmistakably clear that a payment by an employer to an employee, even though includable in the employee's gross income, is not necessarily wages.[57]

The tax treatment of moving expense reimbursements has an interesting history. Prior to 1964, the Code contained no provisions relating to the deductibility of moving expenses.[58] In 1964, § 217 was added to the Code. This section permitted employees to deduct "direct moving expenses," that is, travel expenses and the cost of moving household goods and personal effects to a new place of employment.[59] Indirect moving expenses, or all other expenses related to the move, such as the selling expense of the old house and househunting trip expenses, were not deductible.

In 1965, in *England v. United States*,[60] the Seventh Circuit faced the question of whether a taxpayer had to include in income certain reimbursements for indirect moving expenses, or alternatively, whether such reimbursements were deductible.[61] The court concluded that the indirect costs involved, namely, the cost of meals, lodging, and expenses incidental to securing housing, were part of the employee's personal living expenses and were therefore expressly nondeductible under § 262 of the Code.[62] Moreover, the court stated that since these

57 Allstate Ins. Co. v. United States, 530 F.2d 378 (Ct. Cl. 1976). Humble Oil & Refining Co. v. United States, 442 F.2d 1362 (Ct. Cl. 1971); Humble Pipe Line Co. v. United States, 442 F.2d 1353 (Ct. Cl. 1971).

58 Rev. Rul. 429, 1954-2 C. B. 53 stated:

> Where an employee is transferred in the interest of his employer from one official station to another for permanent duty, the allowance or reimbursement received for moving himself, his immediate family, household goods and personal effects is not includable in the gross income of the employee if the total amount of the reimbursement or allowance is expended for such purpose. Any excess of the allowance or reimbursement over the actual expenses incurred for such purpose is includable in gross income. Any moving expense paid or incurred by the employee in excess of the allowance or reimbursement is not deductible for Federal income tax purposes.

59 To qualify for the deduction, certain location requirements had to be met. The taxpayer's new principal place of work had to be at least 20 miles farther from his old residence than his former principal place of work had been or, if he was a new employee with no former principal place of work 20 miles from his former residence. The taxpayer also had to be employed in the general location of his new principal place of work for at least 39 weeks of the 12-month period immediately following his arrival. *See* Allington, *Moving Expenses and Reimbursements,* 56 A.B.A.J. 495 (1976).

60 345 F.2d 414 (7th Cir. 1965), *cert. denied,* 382 U.S. 986 (1966).

61 *Id.* at 415.

62 *Id.* at 417. I.R.C. § 262 states: "Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses."

personal expenses had been paid by the employer, the employee had realized income includable in his tax return.[63]

The Court of Claims addressed the same issue three years later in *Ritter v. United States.*[64] Like the Seventh Circuit in *England,* the *Ritter* court concluded that reimbursement of employees for indirect moving expenses was equivalent to paying the employees' personal expenses. Accordingly, the court held that the reimbursements were neither excludable from income nor deductible by the employee.[65]

Once it had been established that indirect moving expense reimbursements were taxable income to employees, the government took a further step. In *Humble Pipe Line Co. v. United States*[66] and its companion case, *Humble Oil and Refining Co. v. United States,*[67] the government claimed that the payments constituted wages subject to withholding. But the Court of Claims, citing *Acacia* and *People's Life* as supporting authority, refused to accept the government's argument. The court stated: "If carried to its logical conclusion, defendant's argument here would suggest that every payment, or other economic gain, flowing from an employer to an employee constitutes compensation for services performed upon which withholding is required. Clearly, however, this is not so. . . ."[68]

The court relied on two factors in concluding that the reimbursements were not payments for services and accordingly not wages. First, the court noted that, unlike wages, the reimbursements had no relation to the value of services performed by the employee. Second, the court reasoned that from the employer's viewpoint, the reimbursements were made solely to promote its own legitimate and bona fide business purposes; they were not intended as compensation for employees.[69]

Thus, any lingering doubts as to whether an employer's payment of gross income to an employee invariably constitutes wages were removed by the Court of Claims in the *Humble* cases.[70] Gross income payments are not necessarily wages.

The *Humble* cases were cited in *Royster v. United States,*[71] in which the Fourth Circuit attempted to broaden the distinction between income and wages.

63 345 F.2d at 416.
64 393 F.2d 823 (Ct. Cl. 1968), *cert. denied,* 393 U.S. 844 (1968).
65 *Id.* at 829-30.
66 442 F.2d 1353 (Ct. Cl. 1971).
67 442 F.2d 1362 (Ct. Cl. 1971).
68 *Id.* at 1368.
69 *Id.* at 1353, 1356.
70 The issue addressed in the *Humble* cases surfaced again in Allstate Insurance Co. v. United States, 530 F.2d 378 (Ct. Cl. 1976). The government claimed that the *Humble* cases did not control because the tax years in question in *Allstate* were 1965-1969. Unlike the *Humble* cases, which concerned the 1961 tax year, *Allstate* arose subsequent to the enactment of § 217 and related amendments to the Code. The amendment relied upon by the government was I.R.C. § 3401(a)(15), which provided that withholding was not required for the reimbursement of an employee's *direct* moving expenses. A necessary corollary, the government argued, was that withholding was required for the reimbursement of indirect moving expenses. Once again, however, the Court of Claims rejected the government's argument. The controlling factor, according to the court, was that the reimbursements were not payments for services; thus, no withholding was required.
71 479 F.2d 387 (4th Cir. 1973).

The Seventh Circuit confronted the same issue in *Central Illinois*. Thus, *Royster* was crucial to the outcome of *Central Illinois*.

4. The *Royster* Decision

Several revenue rulings, the "convention" cases, the "moving expense" cases, and other decisions provided authority for the argument that payments from an employer to an employee are not necessarily wages even though they are gross income to the employee.[72] The government finally conceded this point in *Royster*. Despite this concession, however, the government contended that the payments at issue in *Royster* were wages subject to withholding.

Royster Co. manufactured commercial fertilizer and employed a sales force of about 125 persons. During 1965 and 1966, the company reimbursed its salesmen for the cost of meals purchased on the road during the day. Royster failed to withhold F.I.C.A. and employee income taxes on the reimbursements for meals and also did not include the reimbursements in the F.I.C.A. and F.U.T.A. returns that it filed for those years. Consequently, the Commissioner assessed additional taxes and interest against Royster. The company paid the additional assessments then filed timely refund claims. The District Court for the Eastern District of Virginia resolved the issue in favor of Royster, and the government appealed.[73]

Relying on several of the decisions discussed previously, the Fourth Circuit affirmed the district court's decision. The Fourth Circuit stated:

> We agree with those cases cited earlier in this opinion which reject the proposition that wages under the FUTA, FICA and income tax withholding provisions is synonymous with income under the income tax provisions of the Code. We are of the opinion that the term wages is narrower than the term income. . . . Wages are merely one form of income.[74]

The court focused its attention on the issue of whether the reimbursements represented payments for services. The court observed that all a salesman had to do to receive the meal reimbursement was to purchase his meal while on the road. If the salesman did so, he was reimbursed, regardless of his performance. The court observed further that a salesman performed no services while eating, either directly or indirectly. In addition, in the Fourth Circuit's estimation, the arrangement allowed the salesmen to travel fewer miles than if they had to return home to eat. The court therefore concluded that reimbursing salesmen for meal expenses was a legitimate business choice of the employer.[75] In view of these considerations, the court held that the payments in question were not wages as defined in the F.I.C.A., F.U.T.A., and income tax withholding statutes.[76]

The distinction between wages and gross income had thus evolved, through a series of revenue rulings and court decisions, to the point where the Fourth

72 Another case consistent with the *Humble* decisions and relied on by the Fourth Circuit in *Royster* is Stubbs v. Overbeck, 445 F.2d 1142 (5th Cir. 1971). *Stubbs* held that per diem payments to an employee at a remote job site were not wages subject to withholding even though they were income. *But cf.*, Rev. Rul. 371, 1959-2 C. B. 236.

73 479 F.2d at 388.

74 *Id.* at 390.

75 *Id.* at 391.

76 *Id.* at 392.

Circuit concluded in *Royster* that meal reimbursements for non-overnight trips were not wages. By the time *Royster* was decided, even the government was willing to concede that payments of gross income by an employer to an employee are not always tantamount to wages. Nevertheless, in *Central Illinois* the Seventh Circuit refused to accept the narrow interpretation given to wages by the Fourth Circuit and other courts. The Seventh Circuit again threw into question the proper relationship between wages and gross income when it held in *Central Illinois* that meal reimbursements provided an employee on non-overnight business trips are in fact wages subject to withholding.

V. The *Central Illinois* Decision

A. *The Seventh Circuit's Rationale*

The Seventh Circuit began its analysis of the issue in *Central Illinois* by acknowledging that the reimbursements were income to the employees. The court stated further that, in light of the Supreme Court's holding in *United States v. Correll,*[77] the meal expenses incurred by the employees were clearly nondeductible.[78] The Seventh Circuit recognized, however, that not all payments of nondeductible income to an employee fall within the category of "wages." Hence, the question the court addressed was whether the payments were remuneration for services. In answering this question, the Seventh Circuit refused to be confined by the narrow interpretation given to "remuneration for services" by other courts. Instead, the Seventh Circuit looked to language from the Supreme Court and concluded that the reimbursements were indeed wages.

The Seventh Circuit drew upon two Supreme Court decisions, *Commissioner v. LoBue*[79] and *Social Security Board v. Nierotko,*[80] to reject the *Royster* view of wages. In *LoBue* an employee exercised a stock option, given to him by the company, which enabled the employee to purchase stock valued at $9930 for $1700. The Supreme Court stated:

> When assets are transferred by an employer to an employee to secure better services they are plainly compensation. It makes no difference that the compensation is paid in stock rather than money. . . .
>
> . . . .
>
> LoBue received a very substantial economic and financial benefit from his employer prompted by the employer's desire to secure better work from him. This is "compensation for personal service" . . . .[81]

In *Nierotko* the issue was whether "back pay" granted to an employee pursuant to the National Labor Relations Act constituted wages for the purpose of F.I.C.A. and F.U.T.A. taxes. The Supreme Court refused to limit the breadth of the term "service" in determining whether payments received by an employee for a period when he was not actually working were subject to social security

77 389 U.S. 299 (1967). In *Correll,* the Supreme Court held that a taxpayer who travels on business may deduct the cost of meals only if his trips require sleep or rest. Since only non-overnight trips were in issue in *Central Illinois,* the meal expenses were nondeductible.
78 540 F.2d at 301.
79 351 U.S. 243 (1956).
80 327 U.S. 358 (1946).
81 351 U.S. at 247.

taxes. The Court wrote: "We think that 'service' as used by Congress in this definitive phrase means not only work actually done but the entire employer-employee relationship for which compensation is paid to the employee by the employer."[82] Accordingly, the Supreme Court held that back pay was subject to social security taxes.

The Seventh Circuit determined that both of these cases demonstrated that the Supreme Court intended to give "remuneration for services" the same broad interpretation given "gross income." Moreover, in the Seventh Circuit's view, meal reimbursements were part of the "total package of remuneration" that employees demand in exchange for their services. The Seventh Circuit thus concluded that the reimbursements were wages for the purpose of income tax withholding.

B. *Comparing the* Royster *and* Central Illinois *Views*

1. The Legal Perspective

For several reasons, the Seventh Circuit's expansive interpretation of "remuneration for services," or "wages," is preferable to the Fourth Circuit's narrow interpretation in *Royster*. The implication of *Royster* is that payments made by an employer for non-working activities engaged in by an employee are not wages because the employee does not provide services to the employer while performing these activities. This view, however, seems unsound. For example, in *Campbell Sash Works, Inc. v. United States*,[83] an employer provided his employees with an all-expense-paid vacation. No business was transacted during the vacation; it was solely a pleasure trip for the employees. The value of the trip was clearly income to the employees, as the *Campbell* court easily recognized. Furthermore, it was apparent to the court that the employer provided his employees with the vacation not only to reward their past performance but also to improve their future performance. The court concluded, therefore, that the vacation was remuneration for services, albeit past and future services.[84] Thus, the court held the vacation was a form of wages and was subject to withholding. The District Court for the Eastern District of Maryland, faced with a similar issue, reached the same conclusion in *Reliable Life Insurance Co. v. United States*.[85] The Maryland district court noted:

> Obviously, during a vacation period an insurance agent does not personally perform any service. However, as the Supreme Court pointed out in *Nierotko*, the term "service performed" means not only work actually done, but the entire employer-employee relationship for which compensation is paid to the employee by the employer.[86]

Under the *Royster* rationale, however, the above cases would have been decided differently. Since no services were performed during the vacations, no income tax withholding would have been required.

Furthermore, the *Royster* holding would exclude from the definition of

82 327 U.S. at 365-66.
83 217 F. Supp. 74 (N.D. Ohio 1963).
84 *Id.* at 78.
85 356 F. Supp. 235 (E.D. Md. 1973).
86 *Id.* at 239.

wages any payment made in consideration of services performed at other times. This is contrary to the language of the Supreme Court in *Otte v. United States,*[87] where the Court intimated that § 3401 encompasses payments for services performed at other times.[88] As will be discussed more fully below, it is this aspect of the *Royster* decision that could lead to easy circumvention of the income tax withholding statute. Besides meal reimbursements, an employer might pay for a variety of his employees' personal expenses. Because the expenses would not be incurred in the performance of services for the employer, *Royster* suggests that the reimbursements would not be subject to withholding, even though they would clearly be gross income. This would completely defeat the income tax withholding provisions' twofold purpose of preventing an employee from facing a large income tax payment at the end of the year and ensuring a certain flow of tax revenue to the Treasury.[89]

The Seventh Circuit's description of the employer-employee relationship as a "two-sided bargain," and its holding that employee services are given "for a total package of remuneration,"[90] which includes salary, pension, paid vacations, and meal reimbursements, is a more realistic assessment of the relationship between employees and employers than is the narrow *Royster* interpretation. Although it is not dispositive of the issue, it is noteworthy that the amount of meal reimbursements paid to non-salaried employees in *Central Illinois* was established in union negotiations and was part of the employees' overall wage contract with the employer. Obviously, the reimbursements were viewed by employer and employees alike as constituting as much a part of the employees' remuneration for services as their hourly wage rate.

The Seventh Circuit correctly noted that its "total package" characterization of employee wages was in harmony with the view taken by the Second Circuit. This was evident from the Second Circuit's holding in *Educational Fund of the Electrical Industry v. United States.*[91] At issue in that case was a program under which electricians covered by a collective bargaining agreement could attend a one-week course in subjects that ranged from basic thinking processes to constitutional rights. Through labor negotiations, it was decided that each employee would receive $140 upon satisfactory completion of a course.[92] Since the electricians performed no direct services while taking these courses, no income taxes were withheld from the $140 checks. The Second Circuit, however, emphasizing the nature of the employer-employee relationship, held that the payments were wages and required that taxes be withheld. The court stated:

87 419 U.S. 43 (1974).

88 In *Otte* the Supreme Court stated at 49:

> That statute [I.R.C. § 3401], as has been noted, broadly defines "wages" to include, with stated exceptions not material here, "all remuneration." And § 3401 (d), in defining "employer," twice refers to services that the employee "performs or performed." It thus speaks in the past tense as well as the present and thereby plainly reveals that a continuing employment relationship is not a prerequisite for a payment's qualification as "wages." The income tax withholding regulations since 1943 have so provided in specific terms.

See also Rev. Rul. 44, 1975-1 C. B. 15.

89 *But see* 373 F.2d at 933.

90 540 F.2d at 302.

91 426 F.2d 1053 (2d Cir. 1970).

92 *Id.* at 1055.

> The $140 payments were properly characterized as wages under Section 3401(a). . . . The $140 payments to those who attended the school represented part of the benefit package which was negotiated as part of the wage structure under the collective bargaining agreement in effect between the employers and the union as representative of the electrical workers. The payments ultimately derived from the employers and represented a portion of the agreed upon remuneration for services performed by the employees within the intent of Section 3401(a). . . .[93]

The interpretation of "wages" under § 3401(a) provided by the Second and Seventh Circuits is also consistent with the interpretation given this term by the House and Senate in the social security provisions of the Code, which contain language similar to that of the income tax withholding provisions.[94] The House Report on the Social Security Bill stated: "Wages include not only the cash payments made to the employee for work done, but also compensation for service in other forms such as room, board, etc."[95] The Senate Report used basically the same language: "The term 'wages' is defined to mean all remuneration for employment, including the cash value of all remuneration paid in any other medium than cash. That is, in addition to money payments, it includes payments in kind, rent, food, lodging, etc."[96]

The above statements are particularly significant in light of the statement in *Royster,* noted by the Seventh Circuit in *Central Illinois,* that the definition of wages under the income tax withholding and social security tax sections were essentially the same.[97] It is apparent that the House and Senate fully intended to treat compensation in the form of meals as wages under the social security tax provisions. From the viewpoint of employers and employees, an employer's providing a meal for employees is indistinguishable from an employer's reimbursing employees for their meal expenses. In both situations employees receive a free meal from their employer. Accordingly, it is logical to assume that, for social security tax purposes, the House and Senate would treat meal reimbursements as wages just as they treat in kind meal payments as wages. If "wages" has the same essential meaning under the income tax withholding section, it is reasonable to conclude that the House and Senate also intended to treat meal reimbursements as wages under this section.

A further consideration that bolsters the *Central Illinois* holding and undermines *Royster* pertains to the factual setting of these two cases. A comparison of the facts of these cases with the facts of the convention and moving expense cases, which established that a payment of gross income to an employee by an employer is not necessarily wages, reveals that the cases are distinguishable.

A critical distinction between *Royster* and *Central Illinois,* on the one hand, and the convention and moving expense cases, on the other, lies in the nature of the expenses involved in the cases. The meal expenses involved in *Royster* and *Central Illinois* were purely personal expenses, which employees incurred ir-

93 *Id.* at 1056.
94 The Social Security tax provisions include F.I.C.A. and F.U.T.A. taxes. For a discussion of these taxes *see* text accompanying notes 18-28 *supra.*
95 H.R. Rep. No. 615, 74th Cong. 1st Sess. 32 (1939).
96 S. Rep. No. 628, 74th Cong., 1st Sess. 7 (1939).
97 479 F.2d at 390. Cited in 540 F.2d at 302 n.2.

respective of where they worked. Moreover, there was no indication in either of these cases that employees on non-overnight business trips incurred higher meal expenses than they would have faced had they been stationed at their home offices.[98] The expenses connected with the convention/moving expense line of cases, however, were not personal expenses that the employees normally incurred; they were additional expenses incurred by the employees for the benefit of their employer.[99] Thus, unlike the employees in the latter group of cases, the employees in *Royster* and *Central Illinois* suffered no additional financial burden by purchasing their own meals on non-overnight trips away from their place of business. Their outlays for lunches on these trips were in all likelihood equivalent to their expenditures when stationed at the home office.

The Court of Claims in the *Humble* cases expressly acknowledged that the employer's reimbursement of employees for incurring additional financial burdens played a prominent part in the court's refusal to label moving expense reimbursements wages. It stated:

> Properly considered, it would seem that "compensation for services" involves a direct exchange of services performed by the employee in return for salary, bonus, and similar items . . . the moving expense payments here involved were [not] intended to compensate the recipient-employee for services. Instead, they were incurred by Humble in the course of its ordinary business activities and *to prevent its moving employees from suffering a loss.*[100]

Rather than preventing their employees from suffering financial loss, by reimbursing them for lunches, the employers in *Royster* and *Central Illinois* clearly provided the employees with a financial gain, in the form of a free lunch. There is a clear-cut distinction between reimbursing employees for personal expenses regularly incurred, regardless of job location, and reimbursing employees for expenses incurred only for the benefit of the employer.

Another significant distinction between reimbursements for meal expenses for nonovernight trips and reimbursements for moving expenses is that whereas the latter expenses are deductible by the employee, the former are not. Under the Tax Reform Act of 1969, a deduction is now permitted for many indirect moving expenses that had previously not been deductible. Consequently, many moving expense reimbursements have no net effect on income. Although they are includable in income pursuant to § 82 of the Code, an offsetting deduction is permitted for several moving expenses under § 217.[101] It is important to note, however, that although the Code exempts employers from withholding income tax on moving expense reimbursements when it is reasonable to believe that a deduction would be permissible under § 217,[102] the exemption is permitted not because the reimbursement is not remuneration for services, as the *Humble* Court urged. The Code states explicitly in § 82 that the moving expense reimbursement is, in fact, compensation for services. It reads, "There shall be included in gross income (*as compensation for services*) any amount received . . .

98 Brief for Appellant at 6, Central Illinois Public Service Co. v. United States.
99 *See* 373 F.2d 924; 272 F. Supp. 188; 442 F.2d 1352.
100 442 F.2d at 1368 (emphasis added).
101 I.R.C. § 217(b)(1964).
102 I.R.C. § 3401(a)(15).

as a payment for or reimbursement of expenses of moving from one residence to another which is attributable to employment. . . ."[103]

The rationale underlying the exemption thus seems to be that the moving expense reimbursement has no effect on the employee's net income.

The foregoing interpretation of the IRS's reasoning is supported by Revenue Ruling 69-592, where the IRS again declined to impose income tax withholding responsibility on an employer who provides employees with reimbursements that have no effect on their net income. This ruling is of particular interest inasmuch as it pertains to meal reimbursements. The ruling provides:

> Unless it is reasonable to believe, under all the facts and circumstances known to the employer at the time of the reimbursement, that the total per diem allowances paid to an employee during the taxable year will exceed the total of his deductible travel expenses incurred while he is traveling away from home on business, no withholding of income tax is required with respect to per diem allowances paid to cover his meal expenses on trips that do not require sleep or rest.[104]

Therefore, even if a reimbursement is includable in an employee's income, the IRS recognizes that there is no point in requiring an employer to withhold income taxes when the employee can deduct the expenses for which he is reimbursed and therefore has no increase in net income. The IRS has never suggested, however, that income tax withholding is not required because the reimbursements are not remuneration for services.

The employers in *Royster* and *Central Illinois* could not advance the argument that the meal reimbursements did not provide their employees with an increase in net income. The meal reimbursements were income, and the meal expenses were nondeductible. As a result, there was an increase in the employees' net income.

Thus, *Royster* and *Central Illinois* are distinguishable in two respects from the cases that establish that payments of income to an employee are not necessarily wages. First, in *Royster* and *Central Illinois,* the reimbursements were for purely personal expenditures which the employees would have incurred whether or not they were away from their home offices. By contrast, the reimbursements in the latter group of cases pertain to expenses that an employee incurs only for the benefit of his employer. Second, whereas the reimbursements in *Royster* and *Central Illinois* were clearly nondeductible by the employees, the expenses in the moving expense cases are deductible by employees.[105]

103 I.R.C. § 82 (1969) (emphasis added).

104 Rev. Rul. 592, 1969-2 C. B. 193. On the issue of meal reimbursements and withholding taxes, Revenue Ruling 69-592 should be read in conjunction with Revenue Ruling 75-279. Citing *Correll,* Revenue Ruling 75-279 provides that "if at the time of the payment of the allowances it is reasonable for the employer to believe that the employee will receive only allowances for trips that will not require him to stop for substantial sleep or rest, then the allowances are subject to income tax withholding." Rev. Rul. 279, 1975-2 C. B. 409, 410.

The Seventh Circuit did not address the issue of whether Central Illinois had reason to believe in 1963, the tax year in question, that employees' meal expenses would exceed their deductible travel expenses. Nevertheless, this does not detract from the court's analysis from the viewpoint of current taxpayers. Since this comment is directed at current taxpayers, the reasonableness of Central Illinois's conclusion that deductible travel expenses would exceed meal reimbursements will not be examined.

105 Moving expenses are deductible pursuant to I.R.C. § 217. For circumstances in which convention expenses are deductible, see Postelwaite, supra, n.51.

2. The Practical Perspective

The realities of tax collection provide the most compelling reasons for accepting the Seventh Circuit's definition of wages rather than the Fourth Circuit's *Royster* interpretation. The requirement that employers withhold income taxes from meal reimbursements places little additional burden on either employers or employees.

The House and Senate statements set forth previously[106] indicate that, regardless of whether employers withhold income taxes, they should withhold employee F.I.C.A. taxes and pay employer F.I.C.A. and F.U.T.A. taxes for meal reimbursements provided to employees earning less than the F.I.C.A. and F.U.T.A. maximums. Therefore, the requirement that employers also withhold income taxes from meal reimbursements for non-overnight trips would impose only a slightly increased administrative burden on employers and no increased tax burden.[107] Nevertheless, despite the remarks from the House and Senate, in some areas employers currently neither pay nor withhold F.I.C.A. taxes and do not pay F.U.T.A. taxes for meal reimbursements provided to employees earning less than the F.I.C.A. and F.U.T.A. maximums.[108] The classification of meal reimbursements for non-overnight trips as wages would increase not only the administrative burden but also the tax burden of these employers. Employers keep records of all meal reimbursements provided to employees, however, because the reimbursements are a deductible expense for employers. Thus, the increased administrative burden stemming from an obligation to withhold employee income taxes appears reasonable, as does the employers' increased tax burden. In all likelihood, as in *Central Illinois,* the earnings of many employees who receive meal reimbursements exceed the F.I.C.A. and F.U.T.A. maximums.[109] Employers would face no increased tax liability for meal reimbursements advanced to such employees. Hence, employers would face increased tax liability for only a fraction of the meal reimbursements they provide.

A further consideration is that the propriety of permitting employers to escape the payment of F.I.C.A. and F.U.T.A. taxes for meal reimbursements is questionable in light of the language from the House and Senate, which clearly suggests that meal reimbursements should be treated as wages for the purposes of F.I.C.A. and F.U.T.A. taxes.

Employees' legitimate interests clearly benefit from the Seventh Circuit's interpretation of "wages." Employees must include the meal reimbursements in income whether or not they are termed wages. Under the *Central Illinois* rationale employees would not face the yearly task of tabulating and paying taxes on their meal reimbursements, since their employers would already have performed this job for them.

106 *See* text accompanying notes 95-96 *supra.*

107 There is no increased tax burden on an employer unless, of course, the employer fails to withhold the income tax.

108 For example, employers in the Fourth Circuit do not pay F.I.C.A. or F.U.T.A. taxes nor do they withhold F.I.C.A. or income taxes from meal reimbursements given for non-overnight trips.

109 The current F.I.C.A. maximum is $16,500. 41 Fed. Reg. 44,878 (1976). The current F.U.T.A. maximum is $6000. I.R.C. § 3306(b)(1).

The most salient argument against the *Royster* interpretation of wages and in favor of the *Central Illinois* interpretation concerns the practicalities of tax collection. The *Royster* interpretation raises the possibility that employees, either negligently or intentionally, would fail to include meal reimbursements in their tax returns and would thereby evade the tax payment completely. Although the government might eventually detect the evasion during an audit, administrative limitations would prevent the government from making this discovery except in a limited number of cases. Consequently, employees could easily escape taxation on the reimbursements.[110]

Another difficulty with the Fourth Circuit's interpretation of wages is that according to this view there is no reason why an employer could not reimburse his employees for *all* their lunch expenses without the necessity of withholding income tax. Regardless of whether employees are "on the road," they normally provide no services while eating; therefore, according to *Royster* no lunch reimbursement would qualify as wages. An employer might easily fail to withhold income tax on a certain portion of every employee's paycheck and simply claim that that portion represents reimbursements for lunches rather than wages for services performed. Nor is there any reason why this logic could not apply to the reimbursement of a variety of employees' personal expenses. Besides meal reimbursements, employers could claim that the employee's paycheck includes reimbursements for transportation, rent, child care, clothing, and other living expenses. Thus, employers could withhold income taxes on an even smaller percentage of employees' paychecks.[111]

The only legitimate argument against the Seventh Circuit's view of wages seems to be that the government should not be permitted to require employers to act as involuntary and unpaid tax collectors. The shortcoming of this argument, however, is that this is precisely the role that Congress intended that employers should play when the income tax withholding law was enacted over thirty years ago.[112] Furthermore, it would make little sense for Congress and the courts to interpret broadly taxable income yet narrowly construe the most effective means of income tax collection, the withholding provision.

The realities of tax collection clearly militate against the *Royster* view of wages and in favor of the *Central Illinois* view. The Seventh Circuit's position eliminates the possibility of tax evasion by employees. Moreover, it prevents employers from circumventing their tax withholding responsibilities by claiming that a large percentage of an employee's paycheck constitutes reimbursements for personal expenses.

VI. Conclusion

The income tax withholding statute is the government's most effective means of tax collection. Just as importantly, it alleviates employees' burden of

110 Brief for Appellant at 11, Central Illinois Public Service Co. v. United States. *See also Are Nondeductible Meal Allowances Subject to Withholding?* 29 BAYLOR L. REV. 145 (1977). If the evasion is discovered, however, the employee would have to pay taxes and interest on the amount omitted.

111 Brief for Appellant at 25, Central Illinois Public Service Co. v. United States.

112 442 F.2d at 1372 (Davis, J., dissenting).

making one large lump-sum tax payment at the close of the year. The Seventh Circuit's decision in *Central Illinois* is significant because it ensures the continued vitality of this statute.

The Seventh Circuit's expansive interpretation of "wages" is consistent with the purposes of the withholding statute and with the interpretation of wages given to statutory sections similar to the withholding section. Moreover, the Seventh Circuit's contention that employees furnish services in exchange for a total package of remuneration, which includes meal reimbursements, is an accurate assessment of the present-day employment relationship.

The most important aspect of the Seventh Circuit's holding in *Central Illinois* is its implications for tax collection from a practical point of view. Requiring employers to withhold income taxes on meal reimbursements eliminates a potential source of tax evasion for employees. In addition, it prevents employers from easily circumventing their income tax withholding duty by labelling a large percentage of the payments made to employees reimbursements for living expenses rather than wages. Only when an employer has reason to believe that a reimbursement is provided for an expense that is deductible by employees should the employer not be required to withhold income taxes. Meal reimbursements for non-overnight trips clearly do not meet this standard.

From both a legal and a practical perspective, the Seventh Circuit has reached the correct conclusion on this issue in *Central Illinois*.

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