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Case Comments

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CASE COMMENTS

ANTITRUST LAW—BASEBALL RESERVE SYSTEM—CONCERTED CONSPIRACY—STARE DECISIS—CONGRESSIONAL INACTION—PROFESSIONAL BASEBALL REMAINS EXEMPT FROM STATE AND FEDERAL ANTITRUST STATUTES.—In October of 1969, two National League Baseball teams, the St. Louis Cardinals and the Philadelphia Phillies, devised a multiplayer trade. Included in this transaction was Curtis C. Flood, the Cardinals' co-captain and star center-fielder who frequently hit above .300 and was purportedly receiving $90,000 a year for his services at the time. Prior to the announcement of the deal, Flood was not consulted, nor was he given an opportunity to express his opinion in the matter because he had presumably forfeited such a right "fourteen years earlier when, at the age of 18 and without the assistance of any attorney or any other advisor, he signed his first professional baseball contract for an annual salary of $4,000."[1]

Subsequent to his notification of the trade, Flood wrote to the Commissioner of Baseball, Bowie K. Kuhn, and asserted that he had a right to negotiate a contract with teams other than Philadelphia, noting:

> After twelve years in the Major Leagues, I do not feel that I am a piece of property to be bought and sold irrespective of my wishes. I believe that any system which produces that result violates my basic rights as a citizen and is inconsistent with the laws of the United States and of the several states.[2]

In response to this, Kuhn agreed that "as a human being you [Flood] are not a piece of property to be bought and sold" and that this was a basic tenet of our society, but he could not "see its applicability to the situation at hand."[3]

Following this exchange of letters, Flood filed suit[4] in the United States District Court for the Southern District of New York on January 16, 1970, against the twenty-four major league baseball teams, the presidents of the American and National Leagues and the Commissioner of Baseball. The complaint listed four causes of action[5] against baseball's reserve system.[6] The first cause of action

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1 Brief for Petitioner at 5, Flood v. Kuhn, 40 U.S.L.W. 4747 (U.S. June 20, 1972).

2 *Id.*

3 *Id.* at 5-6.

4 The motivation for Mr. Flood's action has been described as:

> Inspired in part by an urge to resist treatment as a chattel (and perhaps also by W. C. Fields' alleged epitaph — "I'd rather be dead than in Philadelphia"), Flood rebelled . . . [and] . . . turned to that other great American pastime, litigation. . . .

Jacobs and Winter, *Antitrust Principles and Collective Bargaining by Athletes: Of Superstars in Peonage,* 81 YALE L. REV. 1, 2 & n. 1 (1971).

5 Summary judgment had been granted to the St. Louis Cardinals and New York Yankees in a separate hearing on a fifth cause of action which determined that neither the operation of concession stands by the former club nor the bidding on broadcasting rights for baseball games by the latter club (through CBS) were violations of the federal antitrust prohibitions. Flood v. Kuhn, 312 F. Supp. 404 (S.D.N.Y. 1970).

6 As described in petitioner's brief, the reserve system is:

> [T]he scheme which binds every American professional baseball player to one team, and which compels team owners, whether competitors or not, to boycott the player property of another team owner — and to boycott any fellow owner to eliminate competition in the recruitment and retention of personnel. (Citations omitted.)

Brief for Petitioner at 5. *See* Flood v. Kuhn, 40 U.S.L.W. 4747 (U.S. June 20, 1972) for specific sections of the Major League Rules which constitute the "reserve system."

charged that the reserve system was violative of federal antitrust laws as an unreasonable restraint of trade under sections 1 and 2 of the Sherman Act.[7] The second and third causes of action were based upon diversity of citizenship, and alleged that the reserve system and the defendants' boycott violated the antitrust and civil rights statutes and the common law of New York, California and other states. The final cause of action asserted that through the reserve system, the defendants had subjected Flood to a form of involuntary servitude and peonage proscribed by the thirteenth amendment, 42 U.S.C. § 1994 (1970) and 18 U.S.C. § 1581 (1970), as well as depriving him of his "freedom of labor" in violation of 29 U.S.C. §§ 102, 103 (1970). The pleadings also requested a preliminary injunction restraining the operation of the reserve system against Flood and an award of treble damages allegedly sustained by him since December 30, 1969.[8]

The District Court denied the preliminary injunction, holding that the probability of success in overturning the long-standing exemption of professional baseball to antitrust law was not sufficient to justify preliminary relief.[9] After a full trial on the merits, the District Court found that professional baseball remained exempt from federal antitrust laws, that such an exemption was within the area preempted from state regulation, and that the reserve system did not constitute any form of involuntary servitude.[10] On appeal, the Court of Appeals adopted the reasoning of the trial court,[11] and the Supreme Court granted certiorari.[12] It was held in a 5 to 3 decision that although the exemption of professional baseball from the antitrust laws was an "established aberration" in light of contrary decisions for other professional sports, the former decisions of *Federal Baseball v. National League*[13] and *Toolson v. New York Yankees, Inc.*[14] were firmly entrenched and any change would be a matter for legislative, not judicial resolution.[15]

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7 15 U.S.C. §§ 1, 2 (1970). Section 1 of the Sherman Act provides:

> Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations is declared to be illegal. . . .

Section 2 of the Act states:

> Every person who shall monopolize or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor. . . .

8 Flood v. Kuhn, 309 F. Supp. 793, 796 (S.D.N.Y. 1970). Section 4 of the Clayton Act, 15 U.S.C. § 15 (1970) provides:

> Any person who shall be injured in his business or property by reason of anything forbidden in the antitrust laws may sue therefor . . . and shall recover threefold the damages by him sustained.

9 Flood v. Kuhn, 309 F. Supp. 793 (S.D.N.Y. 1970).
10 Flood v. Kuhn, 316 F. Supp. 271 (S.D.N.Y. 1970).
11 Flood v. Kuhn, 443 F.2d 264 (2d Cir. 1971).
12 Flood v. Kuhn, 404 U.S. 880 (1971).
13 259 U.S. 200 (1922).
14 346 U.S. 356 (1953).
15 Flood v. Kuhn, 40 U.S.L.W. 4747 (U.S. June 20, 1972). Justices Douglas and Marshall filed separate dissenting opinions and Justice Brennan concurred with these. Justice Powell disqualified himself after a preliminary hearing on the suit because he owned substantial stock in Anheuser-Busch which was associated with one of the defendants, the St. Louis Cardinals.

Judicial Treatment of Professional Baseball in the Past

The *Flood* litigation was the third time in the past fifty years that the Supreme Court had been presented with the question of whether professional baseball is within the ambit of the federal antitrust laws. During this period the Court, along with lower federal courts, formulated various responses to the question.

Not Interstate Commerce

The first of these actions came in 1922 in *Federal Baseball v. National League.*[16] In that case, seven member clubs of the Federal League of Professional Baseball Players sought treble damages under the Sherman Act against their competitor National League. It was argued that the National League had destroyed the Federal League by purchasing some of the latter's constituent teams and induced all of those clubs, except for the plaintiff, to leave the former League. Since the baseball teams were located in various cities and states, the teams frequently crossed state lines. While the Court of Appeals ruled in favor of the reserve system,[17] the Supreme Court rested its decision on narrower grounds. In analyzing the business of giving "exhibitions of baseball" the Court concluded that it did not engage in interstate commerce for the purposes of the federal antitrust laws.[18] In this regard, Justice Holmes commented:

> [T]he fact that, in order to give the exhibitions, the Leagues must induce free persons to cross state lines, and must arrange and pay for their doing so, is not enough to change the character of the business. According to the distinction insisted upon in *Hooper v. California,* . . . the transport is a mere incident, not the essential thing. That to which it is an incident, the exhibition, although made for money, would not be called trade or commerce in the commonly accepted use of those words.[19] (Citations omitted.)

It should be noted that *Hooper v. California,*[20] the case heavily relied upon in *Federal Baseball,* rested on the proposition that the issuance of insurance

16 259 U.S. 200 (1922).

17 This issue was collaterally involved because it was alleged that the reserve system precluded the players of those teams that had crossed over to the National League from signing with any in the Federal League. However, the Court of Appeals found that:

> If the reserve clause did not exist, the highly skillful players would be absorbed by more wealthy clubs, and thus some clubs in the League would so far outstrip others in playing ability that the contests between the superior and inferior clubs would be uninteresting and the public would refuse to patronize them.

National League, Etc. v. Federal Baseball Club of Baltimore, 269 F. 681, 687 (D.C. Cir. 1920).

18 The only reported case on this point prior to *Federal Baseball* was *American League Baseball Club v. Chase,* 86 Misc. 441, 149 N.Y.S. 6 (Sup. Ct. 1914) in which the New York Supreme Court held that organized baseball leagues did not engage in interstate commerce for purposes of the Sherman Act.

19 Federal Baseball v. National League, 259 U.S. at 208-09. This was decided despite the strenuously argued reasoning of the plaintiffs that vaudeville entertainers traveling a theater circuit were subject to the Sherman Act. H. B. Marienelli, Ltd. v. United Booking Offices, 277 F. 165 (S.D.N.Y. 1914). Correspondence courses conducted through the mail constituted commerce among the States. International Textbook Co. v. Pigg, 217 U.S. 91 (1910). Cattle shipments from one state to another constituted commerce for purposes of the antitrust laws, Swift & Co. v. United States, 196 U.S. 375 (1905).

20 155 U.S. 648 (1895).

policies throughout several states did not constitute an engagement in interstate commerce. But in 1944 this decision was implicitly overruled in *United States v. South-Eastern Underwriters Ass'n*[21] which held that a fire insurance company conducting substantial interstate business was subject to the Sherman Act. While Congress responded quickly by passing the McCarran Act[22] in order to clarify the respective state and federal regulations, it became apparent from *South-Eastern Underwriters Ass'n* as well as from *Wickard v. Filburn*[23] and *Mandeville Island Farms v. American Crystal Sugar Co.*[24] that the High Court had reassessed its criterion for classifying interstate commerce activities. Furthermore, the Court drove a deeper wedge into the rationale of *Federal Baseball* when it decided that "personal effort" in the form of medical services was within the ambit of interstate commerce and consequently subject to the federal antitrust laws.[25]

Broadcasting

In part, the cumulative effect of these rulings was the dissipation of the "protective canopy"[26] which had shielded baseball against antitrust attacks from the time of the *Federal Baseball Case* until the late 1940's. Thereafter, the federal courts reanalyzed the "interstate commerce" activities of baseball within a different framework. Instead of focusing upon the crossing of state lines by players, the emphasis shifted to the transmission of radio and television broadcasts across the country and the substantial revenues derived therefrom.[27] While most of these cases were decided on the basis of the controlling precedent of *Federal Baseball*[28] the Court of Appeals for the Second Circuit in *Gardella v. Chandler*[29] refused to fall in line with this movement. Led by Judge Learned Hand, the court reversed the District Court's dismissal[30] of an antitrust complaint filed to recover treble damages by a baseball player who had violated the terms of the reserve clause of his contract by playing professional baseball in Mexico.

21 322 U.S. 533 (1944).

22 § 1, ch. 20, § 1, 59 Stat. 33 (1945), *as amended* 15 U.S.C. 1011 (1970).

23 317 U.S. 111 (1942). The case held that the Agricultural Adjustment Act of 1938, 7 U.S.C. 1281 (1970) (originally enacted as Act of Feb. 16, 1938), which controlled the volume of wheat moving in interstate commerce, was within the Commerce Clause and was applicable to a small farmer in Ohio who used a large portion of his winter wheat crop on his farm while selling the remainder locally.

24 334 U.S. 219 (1948) *overruling United States v. E. C. Knight Co.*, 156 U.S. 1 (1895) which had held that an intrastate refiner of sugar who shipped and sold the sugar through interstate means was beyond Congress' power to regulate through the antitrust laws because such activity was only "remote" and "incidental."

25 American Medical Ass'n v. United States, 317 U.S. 519 (1943).

26 2 H. Seymour, *Baseball* 420 (1971).

27 Gardella v. Chandler, 79 F. Supp. 260 (S.D.N.Y. 1948), *rev'g* 172 F.2d 402 (2d Cir. 1949); Martin v. National League Baseball Club, 174 F.2d 917 (2d Cir. 1949); Toolson v. New York Yankees, 101 F. Supp. 93 (S.D. Cal. 1951), *aff'd* 200 F.2d 198 (9th Cir. 1952); Kowalski v. Chandler, 202 F.2d 413 (6th Cir. 1953).

28 All the cases in note 22 *supra* held this except *Gardella v. Chandler,* 172 F.2d 402 (2d Cir. 1949). *Cf.* Niemiec v. Seattle Rainier Baseball Club, Inc., 67 F. Supp. 705 (W. D. Wash. 1946). Also, until this time, *Federal Baseball* had been cited with approval by the Supreme Court on three separate occasions: Hart v. B. F. Keith Vaudeville Exchange, 262 U.S. 271 (1923); United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1943); North American Co. v. Securities and Exchange Com., 327 U.S. 686 (1946).

29 172 F.2d 402.

30 79 F. Supp. 260.

As a result of this action, the plaintiff was temporarily barred from playing with organized baseball clubs. In light of this, Judge Hand seized upon other allegations by the plaintiff and stated that the advent of nationwide radio and television broadcasts in conjunction with the interstate movement of teams was enough to taint the entire professional baseball business with shades of "interstate commerce" for purposes of the federal antitrust statutes.[31]

In agreement with Judge Hand on the *Gardella* court was Judge Frank who recognized the fact that *Federal Baseball* was "an impotent zombi,"[32] but hesitated to overrule it.[33] Nonetheless, he caustically remarked:

> I think it [*Federal Baseball*] should be distinguished, if possible because . . . we have here a monopoly which, in its effect on ball players like the plaintiff, possesses characteristics shockingly repugnant to moral principles that, at least since the War Between the States, have been basic in America, as shown by the Thirteenth Amendment to the Constitution, condemning "involuntary servitude," and by subsequent Congressional exactments on that subject. For the "reserve clause," as has been observed, results in something resembling peonage of the baseball player.[34] (Citations omitted.)

Judge Frank also cited the fact that the present technology of direct and instantaneous interstate transmission, via television, had the effect of placing viewers "virtually present at these games."[35] Distinquishing this from the *Federal Baseball*'s era of telegraphing reports of games, he commented:

> That degree of difference, known to anyone who has ever sat at the receiving end of a television set, is so great as to constitute a difference of kind. To be sure, no one can draw a sharp line between differences of "degree" and "kind." However, to the question whether the difference of kind and difference of degree is itself a difference of degree or of kind, the sage answer has been given that it is a difference of degree, but a "violent one."[36] (Citations omitted.)

Judge Frank thereupon concluded that the cumulative effect of such interstate broadcasts alone, without the traveling-across-state-lines element included by Judge Hand, was enough to make the business of baseball interstate commerce.[37]

Exemption Theory

The net effect of this taking up of the cudgels by these two eminent jurists[38] was that the Supreme Court was again called into play in *Toolson*

31 172 F.2d at 408.
32 *Id.* at 409.
33 *Id.* at 409, n. 1.
34 *Id.* at 409.
35 *Id.* at 412.
36 *Id.*
37 The *Gardella* litigation was eventually settled out of court for a reported $60,000 and the lifting of the suspension against the plaintiff. H. R. Rep. 2002, 82d Cong., 2d Sess. 84 (1952).
38 *See* Martin v. National League Baseball Club, 174 F.2d 917, 918 (2d Cir. 1949). *See generally* Associated Press v. United States, 326 U.S. 1 (1945) holding that the inter-

v. New York Yankees, Inc.[39] But like an umpire who has been entreated to reconsider his call, the majority unwaveringly reaffirmed *Federal Baseball* in a short per curiam opinion.[40] This decision carefully avoided any reconsideration of the question of interstate commerce, but shifted emphasis to the reliance by team owners and entrepreneurs on baseball's continued antitrust exemption. Correspondingly, the Court accentuated the role of Congress in the antitrust regulation of professional baseball and proceeded on the presumption that congressional inaction on the subject was the equivalent of an acquiescence to the holding of *Federal Baseball.* The Court therefore concluded that if there were changes in the field of baseball which merited the application of the antitrust laws, it was up to Congress to so legislate.

This reasoning was rejected by Justice Burton who, along with Justice Reed, dissented in the case. In excepting himself from the majority, Justice Burton recounted the vast expansion of professional baseball into a multi-million dollar investment. On the basis of this, he then stated, "it is a contradiction in terms to say that the defendants . . . are not now engaged in interstate commerce or trade as those terms are used in the Constitution of the United States and in the Sherman Act."[41] He also refuted the majority's assertion that by its silence, Congress had excluded baseball from antitrust regulation by reminding his brethren that Congress had explicitly exempted certain areas such as labor organizations, farm cooperatives and insurance from the federal antitrust statutes.[42] He then wrote:

> In the absence of such an exemption, the present popularity of organized baseball increases, rather than diminishes, the importance of its compliance with standards of reasonableness comparable with those now required by

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state transmission of news was within the scope of interstate commerce for purposes of the federal antitrust statutes.

39 346 U.S. 356 (1953), *reh. denied* 346 U.S. 917 (1953). The decision encompassed three separate cases, Toolson v. New York Yankees, 101 F. Supp. 93 (S.D.Cal. 1951), *aff'd* 200 F.2d 198 (9th Cir. 1952); Kowalski v. Chandler, 202 F.2d 413 (6th Cir. 1953); and Corbett v. Chandler, 202 F.2d 428 (6th Cir. 1953). All three actions were brought by professional baseball players seeking recovery of treble damages for alleged violations of the federal antitrust laws. *Toolson* involved a refusal to report to an assigned baseball club by the player and pursuant to his contract he was then placed on the "ineligible list" and prohibited from playing. *Kowalski* and *Corbett* concerned assertions that through the players' contracts and agreements among the clubs, the plaintiffs were deprived of the reasonable value of their services and opportunities for professional promotion.

40 The per curiam opinion reads as follows:

> In *Federal Baseball Club of Baltimore v. National League of Professional Baseball Clubs* . . . this Court held that the business of providing public baseball games for profit between clubs of professional baseball players was not within the scope of the federal antitrust laws. Congress has had the ruling under consideration but has not seen fit to bring such business under these laws by legislation having prospective effect. The business has thus been left for thirty years to develop, on the understanding that it was not subject to existing antitrust legislation. The present cases ask us to overrule the prior decision and, with retrospective effect, hold the legislation applicable. We think that if there are evils in this field which now warrant application to it of the antitrust laws it should be by legislation. Without re-examination of the underlying issues, the judgments below are affirmed on the authority of *Federal Baseball Club of Baltimore v. National League of Professional Baseball Clubs* (U.S.) *supra,* so far as that decision determines that Congress has no intention of including the business of baseball within the scope of the federal antitrust laws.

346 U.S. at 356-57. (Citations omitted.)

41 346 U.S. at 358 (Justice Burton dissenting).

42 *Id.* at 364.

> law of interstate trade or commerce and, as such, it is subject to the Sherman Act until exempted.[43]

A little over a year later the Supreme Court had occasion to comment on baseball's exemption once more in *United States v. Shubert.*[44] This case involved an alleged violation of sections 1 and 2 of the Sherman Act by persons producing and booking legitimate theatre attractions throughout the country. The District Court had dismissed the complaint on the authority of *Federal Baseball* and *Toolson,* stating that like baseball, such booking and producing activities were "local exhibitions" and therefore not interstate commerce for purposes of the antitrust laws.[45] The Supreme Court, however, balked at such a broad application of these decisions and stated that they were confined to the business of baseball. As such, the Court noted that its recent *Toolson* holding had not "necessarily reaffirm[ed] all that was said in *Federal Baseball*" but merely determined that "Congress had no intention of including the business of baseball within the scope of the Federal antitrust laws."[46] Thus, the Court concluded that *Toolson* "was a narrow application of the rule of *stare decisis*" and if it was "to be expanded—or contracted—the appropriate remedy lies with Congress."[47]

Moreover, in a companion case to *Shubert, United States v. International Boxing Club,*[48] the Court adhered to its restricted view of *Toolson* and *Federal Baseball* and refused to extend such holdings to the professional sport of boxing. In so holding, the Court noted four recent bills which had been proposed in Congress "forbidding the application of the antitrust laws 'to organized professional sports enterprises or to acts in the conduct of such enterprises.' "[49] But the Court cited with approval the Report by the House Subcommittee on the Study of Monopoly Power of the Committee on the Judiciary which recommended against passage of the bills, stating "[s]uch a broad exemption could not be granted without substantially repealing the antitrust laws."[50]

Notwithstanding the majority's resolution, Justices Frankfurter and Minton filed separate dissenting opinions in *International Boxing Club.* Justice Frankfurter incisively commented that "[i]t would baffle the subtlest ingenuity to find a single differentiating factor between other sporting exhibitions" and baseball inasmuch as "the conduct of the sport is relevant to the criteria or considerations by which the Sherman Law becomes applicable to a 'trade or commerce.' "[51] In thus finding no distinctions between boxing and baseball for these purposes, he then took issue with the majority's restricted interpretation of *Toolson* by reminding his brethren that the decision was an application of the doctrine of *stare decisis*:

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43 *Id.* at 365.
44 348 U.S. 222 (1955).
45 United States v. Shubert, 120 F. Supp. 15 (S.D.N.Y. 1953).
46 348 U.S. at 230.
47 *Id.*
48 *Id.* at 236.
49 H. R. 4229, 4230, 4231 and S. 1526, 82d Cong., 1st Sess. (1951).
50 348 U.S. at 244.
51 *Id.* at 248 (Justice Frankfurter dissenting).

> That doctrine is not, to be sure, an imprisonment of reason. But neither is it a whimsy. It can hardly be that this Court gave a preferred position to baseball because it is the great American sport. I do not suppose that the Court would treat the national anthem differently from other songs if the nature of a song became relevant to adjudication. If stare decisis be one aspect of the law, as it is, to disregard it in identical situations is mere caprice.[52]

Justice Minton also took a jab at the majority's ruling:

> When boxers travel from State to State, carrying their shorts and fancy dressing robes in a ditty bag in order to participate in a boxing bout, which is wholly intrastate, it is now held by this Court that the boxing bout becomes interstate commerce. What this Court held in the Federal Baseball Case to be incident to the exhibition now becomes more important than the exhibition. This is as fine an example of the tail wagging the dog as can be conjured up.[53]

In the wake of this criticism, the ghosts of *Toolson* and *Federal Baseball* returned to haunt the Supreme Court two years later in *Radovich v. National Football League*.[54] This case involved a consideration of whether the activities of professional football teams, with their "reserve clauses" binding football players, constituted a "conspiracy to monopolize and control organized professional football" in violation of the Sherman Act.[55] The respondent National Football League, argued that the doctrines of *Toolson* and *Federal Baseball* applied to all "team sports."[56] However, speaking for the Court, Justice Clark reiterated the position that: "As long as the Congress continues to acquiesce we should adhere to—but not extend—the interpretation of the [Sherman] Act made in those cases."[57]

The *Radovich* decision demonstrated a shaky allegiance to the *Toolson* case. The Court conceded that it had affirmed *Federal Baseball* in *Toolson* because of the development and organization of baseball in reliance on the former ruling and the flood of litigation which would have resulted from its overruling.[58] The Court then stated:

> If this ruling [*Radovich*] is unrealistic, inconsistent, or illogical, it is sufficient to answer, aside from the distinctions between the businesses, that were we considering the question of baseball for the first time upon a clean slate we would have no doubts. But *Federal Baseball* held the business of baseball outside the scope of the Act. No other business claiming the coverage of

52 *Id.* at 249.
53 *Id.* at 251 (Justice Minton dissenting).
54 352 U.S. 445 (1957).
55 *Id.* at 447. An earlier decision had considered the problem of certain bylaws of the National Football League dealing with the telecasting of games. It was held that unreasonable restrictions on radio broadcasts of football games in specified localities and the general power of the Commissioner of the League to prevent all television and radio broadcasts were enjoinable under the federal antitrust laws. United States v. National Football League, 116 F. Supp. 319 (D.C.Pa. 1953).
56 352 U.S. 447.
57 *Id.* at 451. Justices Harlan and Brennan, while dissenting, concurred with this statement. *Id.* at 456.
58 *Id.* at 450.

> those cases has such adjudication. We, therefore, conclude that the orderly way to eliminate error or discrimination, if any there be, is by legislation and not by court decision.[59]

Despite the Court's urging, Congress failed to clarify baseball's status under the antitrust laws. While a number of bills were introduced immediately after *Radovich* and for the next few years, none could muster enough support to pass both houses.[60] The only pertinent legislation, which was finally enacted in 1966, was a feeble conglomeration of prior court rulings.[61]

Although this action by Congress gave the judiciary a temporary reprieve from the controversy over baseball's exemption, the issue was soon raised again by two discharged baseball umpires who had attempted to unionize their American League colleagues. In *Salerno v. American League of Prof. Baseball Clubs*,[62] the plaintiffs attempted to secure federal jurisdiction for their claims of wrongful discharge by joining them with assertion of general antitrust violations by professional baseball. Nonetheless, the plaintiffs' pleadings were defeated with constrained sympathy from the court. In writing the decision, Judge Friendly empathized with the plaintiffs' argument that greatly increased revenues from the interstate television broadcasts made "baseball's immunity from the antitrust laws more anomalous than ever."[63] He further remarked:

> We freely acknowledge our belief that *Federal Baseball* was not one of Mr. Justice Holmes' happiest days, that the rationale of *Toolson* is extremely dubious and that, to use the Supreme Court's own adjectives, the distinction between baseball and other professional sports is "unrealistic," "inconsistent" and "illogical."[64] (Citations omitted.)

But the gist of *Salerno* was that the plaintiffs had missed the point of the *Toolson* decision. For the latter case was decided upon the ground that "Congress had no intention to bring baseball within the antitrust laws, not that baseball's activities did not sufficiently affect interstate commerce."[65] Despite this holding, the Court of Appeals found hope in the recent decision of *Boys Markets, Inc. v.*

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59 *Id.* at 452. Justices Frankfurter, Harlan and Brennan dissented because they failed to see a distinction between football and baseball in light of the antitrust laws. *Id.* at 455-56.

60 *See* Flood v. Kuhn, 40 U.S.L.W. 4747, 4754 & n.17 (U.S. June 20, 1972) which discusses these bills.

61 15 U.S.C. 1294 (1970) reads:

> Nothing contained in this chapter shall be deemed to change, determine, or otherwise affect the applicability or nonapplicability of the antitrust laws to any act, contract, agreement, rule, course of conduct, or other activity by, between, or among persons engaging in, conducting, or participating in the organized professional team sports of football, baseball, basketball, or hockey. . . .

See Petro v. Madison Square Garden Corp., 1958 Trade Cases, ¶69, 106 (S.D.N.Y. 1958) (hockey is subject to federal antitrust statutes) and Washington Professional Basketball Corp. v. National Basketball Ass'n, 147 F. Supp. 154 (S.D.N.Y. 1956); Denver Rockets v. All-Pro Management, Inc., 325 F. Supp. 1049 (C.D. Cal. 1971); Haywood v. National Basketball Ass'n, 401 U.S. 1204 (Douglas, Circuit Justice, 1971) (all holding basketball subject to federal antitrust laws).

62 429 F.2d 1003 (2d Cir. 1970), *cert. denied sub nom.* Salerno v. Kuhn, 400 U.S. 1001 (1971).

63 429 F.2d 1005.

64 *Id.*

65 *Id.*

Retail Clerks Union[66] in which the Supreme Court overruled *Sinclair Refining Co. v. Atkinson*[67] on the grounds that the latter case was incongruous with the underlying nature of the statute it had construed (Norris-LaGuardia Act), and that congressional inaction to rectify the *Sinclair* judgment was not indicative of that body's adoption of it.[68] Nonetheless, the Court of Appeals declined the plaintiff's invitation to similarly overrule the *Toolson* decision itself:

> [W]e continue to believe that the Supreme Court should retain the exclusive privilege of overruling its own decisions, save perhaps when opinions already delivered have created a near certainty that only the occasion is needed for pronouncement of the doom. While we should not fall out of our chairs with surprise at the news that *Federal Baseball* and *Toolson* had been overruled, we are not at all certain the Court is ready to give them a happy despatch.[69]

The *Flood* Decision

The "happy despatch" of baseball's exemption from antitrust regulation became less certain when the United States District Court for the Southern District of New York announced its decision of *Flood v. Kuhn* after a trial on the merits.[70] The trial court liberally construed Flood's claims[71] so as to obtain "a complete record covering not only the threshold question of whether plaintiff states a cause of action, but the merits of his claims as well."[72] As to the merits, the court divided its opinion into four major considerations: the reserve clause, the federal antitrust claim, the state antitrust claims and the involuntary servitude allegations.[73]

The court found no antitrust violation with respect to Flood's claim that the reserve system constituted a group boycott on the part of the defendants to keep him from playing baseball with a team other than Philadephia. In arriving at this conclusion, the court confessed that before the trial its feeling was that the system was filled with "rampant abuse."[74] After the trial, however, the court noted that a reserve system was not "wholly undesirable" and in fact "substantial

66 398 U.S. 235 (1970).
67 370 U.S. 195 (1962).
68 The Court in *Boys Markets, Inc.* also found itself not bound by the doctrine of stare decisis because it stated that *Sinclair Refining* was not in harmony with other decisions underlying the statute it purportedly interpreted. As for the assertion that Congressional silence on the matter was the equivalent to an acquiescence by that body to the holding in *Sinclair*, the Court replied that "the mere silence of Congress is not a sufficient reason for refusing to reconsider the decision." 398 U.S. at 242.
69 429 F.2d 1005.
70 316 F. Supp. 271 (S.D.N.Y. 1970). *Salerno* was handed down on July 13, 1970 by the Court of Appeals for the Second Circuit and the *Flood* decision was announced by the District Court for the Southern District of New York on August 12, 1970.
71 *Id.* at 273. According to the court's own report, it took three weeks to try the case and the record consisted of over two thousand pages of transcripts and fifty-six exhibits.
72 *Id.* at 285.
73 A fifth question was considered, *viz.*: whether the reserve system as a mandatory subject of collective bargaining was exempt from the antitrust laws. However, the court simply repeated the claim made by the defendant and curtly disposed of the matter by stating:
> We need not reach this difficult question in light of our disposition that the Supreme Court alone is privileged to overrule *Toolson* and hold baseball subject to the antitrust laws. 316 F. Supp. at 278.
74 *Id.* at 276.

portions [were] meritorious."[75] But the District Court never came to grips with the real crux of the problem—that is, whether the reserve clause system *was in fact a concerted refusal to deal,* regardless of whether there were beneficial aspects to it. Even if it had considered this, however, it is doubtful that the result would have been different. For in considering the underlying issue of baseball's exemption from the antitrust laws, the court concluded that the recent *Salerno* decision had denied claims that changes in baseball since *Toolson* required a reexamination of that case. Thus, any such reexamination would have to come from the Supreme Court or Congress.[76]

Perhaps expecting a rejection of his federal antitrust claim, Flood argued that the defendants could not "have it both ways; that if the federal antitrust laws do not reach baseball, then state antitrust . . . statutes and common law are applicable."[77] This claim appeared to be on *Federal Baseball*'s conclusion that baseball exhibitions were "purely state affairs."[78] With regard to this, the District Court said that the plaintiff had ignored the *Toolson* holding which rested on the fact that "Congress had no intention to bring baseball within the antitrust laws, not that baseball's activities did not sufficiently affect interstate commerce."[79] The court then cited the Wisconsin Supreme Court decision of *Wisconsin v. Milwaukee Braves, Inc.,*[80] which had rejected a state antitrust claim on the basis of the commerce and supremacy clauses of the Constitution, stating: "As we see it, application of various and diverse state laws here would seriously interfere with league play and the operation of organized baseball."[81]

Flood's final claim that he had been subjected to a form of involuntary servitude in violation of the thirteenth amendment and legislation thereunder was dismissed by the court because of the plaintiff's failure to show the prerequisite that he was compelled to play baseball. The court admitted that Flood, in not reporting to Philadelphia, was precluded from playing professional baseball and that this was "a consequence to be deplored,"[82] but noted that other alternatives were open to him:

> [H]e has the right to retire and to embark upon a different enterprise outside organized baseball. The financial loss he might thus sustain may affect his choice, but does not leave him "no way to avoid continued service."[83]

Ultimately, however, the District Court refused to decide the fairness of the reserve clause, and thus wrote:

75 *Id.* The court heard the testimony of such former stars as Jackie Robinson and "Hank" Greenberg and club owner William Veeck among others. In light of their statements, the court noted that "[w]ith the sole exception of plaintiff himself . . . [c]learly the preponderance of credible proof does not favor the elimination of the reserve clause." *Id.*

76 *Id.* at 278.

77 *Id.*

78 259 U.S. 200, 208 (1922).

79 316 F. Supp. at 279.

80 31 Wis. 2d 699, 144 N.W.2d 1 (1966), *cert. denied,* 385 U.S. 990 (1966). *Cf.* United States v. Darby, 312 U.S. 100, 119 (1941).

81 316 F. Supp. 280.

82 *Id.* at 281.

83 *Id. citing* United States v. Shackney, 333 F.2d 475, 486 (2d Cir. 1964). *But see* Judge Frank's incisive comments on the chances of a baseball player's success at a different occupation in *Gardella v. Chandler,* 172 F.2d 402, 410 (2d Cir. 1949).

> For the first time in almost fifty years opponents and proponents of the baseball reserve system have had to make their case on the merits and support it with proof in a court of law. . . . Existing and, as we see it, controlling law renders unnecessary any determination as to the fairness or reasonableness of this reserve system. We are bound by the law as we find it and by our obligation to "call it as we see it."[84] (Footnotes omitted.)

The Court of Appeals affirmed the dismissal of the plaintiff's complaint. In so doing, the court took its turn in weighing *Federal Baseball, Toolson,* and its own *Salerno* holding in light of the present *Flood* action, and concluded:

> We readily acknowledge that plaintiff is caught in a most frustrating predicament, a predicament which defendants have zealously seized upon with great perspicacity. On the one hand, the doctrine of stare decisis binds the plaintiff because of an initial holding that baseball is not "interstate commerce" within the Sherman Act, and, on the other hand, after there have been significant changes in the definition of "interstate commerce," he is now told that baseball is so uniquely interstate commerce that state regulation cannot apply. However, in our own defense, we do not consider our decision to be internally inconsistent. In disposing of the Sherman Act count in plaintiff's complaint, we are bound by Supreme Court decision, while in our disposition of the state and common law counts, we must of necessity decide this question of first impression by present Commerce Clause standards and not the standards applicable in 1922. Any apparent inconsistency results not from faulty logic, but from the vagaries of fate and this court's subordinate role to the Supreme Court.[85] (Footnotes omitted.)

With that, the Supreme Court was given its third opportunity to review the "national pastime."[86] In what was perhaps the most nostalgic preface to a decision in the history of the Supreme Court,[87] Justice Blackmun laid to rest the

84 316 F. Supp. 284-85. The court concluded its opinion with the observation that the conflicts which led Flood to institute the present suit were not irreconcilable and that he should pursue further negotiations under the auspices of the Major League Baseball Player's Association. *Id.* at 282-83.

85 Flood v. Kuhn, 443 F.2d 264 at 268 (2d Cir. 1971). In a concurring opinion, Judge Moore terminated his discussion with the resolution:

> [L]imit the participation of the courts in the conduct of baseball's affairs to the throwing out by the Chief Justice (in the absence of the President) of the first ball of the baseball season. *Id.* at 273.

86 Flood v. Kuhn, 40 U.S.L.W. 4747 (U.S. June 20, 1972).

87 Justice Blackmun's opinion was broken down into five segments with the first part consisting of his touching tribute to baseball. He began this initial section by devoutly recalling the first baseball game played by the New York Nine and the Knickerbockers on June 19, 1846 and then proceeded with a mythic recollection of eighty-seven former players who "have sparked the diamond and its environs and that have provided tinder for recaptured thrills. . . ." *Id.* at 4748. He also added a poetic touch to the decision by reciting the chant of "Tinker to Evers to Chance," Ernest L. Thayer's tale of "Casey at the Bat," and other prose by Franklin Pierce Adams and Grantland Rice. *Id.* One commentator has succinctly described the effect of this with the statement "[j]udicial impartiality blurs somewhat when the author wears his heart on his sleeve." 118 CONG. REC. 10149 (1972) (reprint of article by Tom Dowling).

Chief Justice Burger and Justice White, while concurring with Justice Blackmun's opinion, specifically excepted themselves from this first part. Also, it is speculated that originally Chief Justice Burger was on the Flood side and after Justice Blackmun wrote his decision the Court was split 4-4 on the issue. Thus, in lieu of rendering no decision on the case which would prove embarrassing to the Court, especially after the publicity which had been given to the *Flood* suit, Chief Justice Burger switched. 118 CONG. REC. 10148 (1972) (reprint of article by Tom Dowling).

possibility of any future litigation on the subject of baseball's antitrust exemption. He began his analysis with the candid admission that "[p]rofessional baseball is a business and it is engaged in interstate commerce"[88]—a fact which had become very obvious to the Court of Appeals[89]—but insisted that this did not require the overruling of *Federal Baseball* and *Toolson*. In fact, while admitting that these two decisions plus *Shubert, International Boxing* and *Radovich* may all be anomalies insofar as they pertain to the baseball exemption, Justice Blackmun concluded that they are "fully entitled to the benefit of *stare decisis*."[90]

But the opinion did not rely solely on the doctrine of stare decisis. It suggested that baseball's exemption was justified by the sport's "unique characteristics and needs."[91] This unelaborated assertion was the only comment made in support of the reserve system which eliminates all competition in the recruitment[92] and retention of personnel, and achieves enforcement of this by a group boycott.[93] Thus, the *Flood* Court apparently accepted respondents' arguments that professional baseball has an extraordinary need to maintain balanced competition, the preservation of integrity and public confidence, and unusually high costs of player development.[94] Yet, the Court had rejected such claims in its *Radovich* opinion[95] and has consistently held that group boycotts cannot be justified by allegations that they are reasonable or that they are beneficial in specific circumstances.[96]

Buttressing its argument for baseball's continued exemption, the Court cited the inaction of Congress in allowing baseball to "expand unhindered by federal legislative action" as evidence of that body's intention not to "subject baseball's reserve system to the reach of the antitrust statutes."[97] This struck a highly controversial note for some members of the High Court, however, with Justice Douglas in dissent stating:

> Nor does want of specific Congressional repudiation serve as an implied instruction by Congress to us not to reconsider, in the light of new experience . . . those decisions. . . . Various considerations of parliamentary tactics and strategy might be suggested for the inaction . . . of Congress, but they

88 40 U.S.L.W. at 4754.
89 443 F.2d at 267.
90 40 U.S.L.W. at 4754. Justice Blackmun summarized the apparent illogic of his adherence to the stare decisis doctrine by stating that "there is merit in consistency even though some might claim that beneath that consistency is a layer of inconsistency." *Id.* at 4755.
91 *Id.* at 4754.
92 Baseball's reserve system has become even more restrictive since *Toolson,* with the institution of the semiannual draft. This procedure abolished any freedom of contract or competitive bidding in the initial signing of aspiring major leaguers. Thus, the drafted player can only negotiate with the team that drafted him to the exclusion of all other teams unless he waits for the next draft.
93 Brief for Petitioner at 17.
94 Brief for Respondents at 6-10.
95 352 U.S. at 450-51.
96 *See United States v. General Motors Corp.,* 384 U.S. 127 (1966) holding that a "location clause" of a franchise agreement while lawful and desirable was still a conspiracy in restraint of trade and a per se violation of the antitrust law; *Klor's Inc. v. Broadway-Hale Stores, Inc.,* 359 U.S. 207 (1959) which stated that "[g]roup boycotts, or concerted refusals . . . to deal . . . have not been saved by allegations that they were reasonable in the specific circumstances." (359 U.S. at 212); *Fashion Originators' Guild v. FTC,* 312 U.S. 457 (1941) which noted that the beneficial results of boycotts of retailers engaged in "style piracy" sales "is no more material than would be the reasonableness of prices fixed by lawful combination" (312 U.S. at 468).
97 40 U.S.L.W. at 4754.

> would only be sufficient to indicate that we walk on quicksand when we try to find in the absence of corrective legislation a controlling legal principle.[98]

Another justification for the Court's ruling was the reliance of the baseball industry on its continued antitrust exemption. This element was in fact weighed by the Court in its concern over the potential "confusion and the retroactivity problems that inevitably would result with a judicial overturning of *Federal Baseball*."[99] But the "reliance interests" argument is of questionable propriety. For with the exception of the above conclusory statement, the Court failed to analyze substantively the merits of this claim. Also, in the past, similar contentions were discredited by the Court when it decided that boxing was subject to the antitrust laws.[100]

Furthermore, the actual degree of "reliance" by professional baseball investors on the continuing viability of the *Federal Baseball* and *Toolson* doctrines is dubious. As the Court itself admitted in *Flood,* "the slate with respect to baseball, is not clean. Indeed, it has not been clean for half a century."[101] It is not unreasonable to expect that such investors would be aware of the erosion of *Federal Baseball* and that the Supreme Court might eventually eliminate the baseball exemption. As one writer stated in this regard:

> Any good lawyer, asked about the reasonableness of reliance upon the aging precedent of *Federal Baseball* and *Toolson* would have counselled that reversal was at least a good possibility.[102] (Footnotes omitted.)

Indeed, the testimony of post-*Toolson* purchasers of baseball teams indicated that they *were* advised of the possibility of such changes coming from Congress.[103] Thus, perhaps the real "reliance" was on the ability of professional baseball "to *lobby* in Congress so as to prevent unduly adverse legislation."[104] Yet, as the petitioner remarked:

> Is this the stuff of which "reliance interest" is made? Wishful thinking about lobbying skill, however well-advised, is simply not "reliance" in a jurisprudential sense. It is opportunism.[105]

Whatever its reasons may have been, the Court could have resolved the reli-

98 *Id.* at 4756 n.3 *citing* Helvering v. Hallock, 309 U.S. 106, 119-21 (1940). Justice Brennan concurred with Justice Douglas in dissent.

99 *Id.* at 4754.

100 *See International Boxing Club v. United States,* 358 U.S. 242 (1959) where the rejection of such claims included the divestiture of boxing interests going back to 1949. Responding to this action, Justice Harlan dissented in part, stating:

> . . . I think it reasonable to say that in 1949 when this alleged conspiracy began most well informed lawyers believed that professional boxing, like professional baseball, was beyond antitrust stricture. *Id.* at 267.

101 40 U.S.L.W. at 4754.

102 Note, *Prospective Overruling and Retroactive Application in the Federal Courts,* 71 YALE L. J. 907, 947 (1962). *Cf.* Morgane v. States Marine Lines, 398 U.S. 375, 404 (1970) *overruling* The Harrisburg, 119 U.S. 199 (1886).

103 Brief for Petitioner at 24.

104 *Id.* at 25.

105 *Id.*

ance and retroactivity difficulties by ruling prospectively[106] instead of deferring to the inaction of Congress.[107] This tactic would have shifted the burden to Congress to come forth with a clear and definitive statement on the matter. For while the *Flood* opinion may be justified on various grounds, there is no guarantee that Congress will act in the future to overrule the baseball decisions which the Supreme Court has now come to "loathe."[108]

Finally, with respect to negotiations on the reserve system between baseball owners and player representatives, the Supreme Court's action is a reaffirmation of the status quo prior to the institution of the *Flood* litigation. Since collective bargaining negotiations on the reserve system were suspended pending the outcome of the *Flood* case,[109] this means that unless Congress overcomes its reticence, any inroads into the reserve system will be realized only through such negotiations. However, if the collective bargaining system is the only recourse left for the players, the prediction of "a baseball strike next year that would make this year's walkout seem like a friendly misunderstanding"[110] may well occur.

Nonetheless, oblivious to this possibility, the Court resolutely concluded:

> [W]hat the Court said in *Federal Baseball* in 1922 and what it said in *Toolson* in 1953, we say again here in 1972: the remedy, if any is indicated, is for congressional and not judicial, action.[111]

The Supreme Court thus called the third strike to end the "legal ball game." It has retired from its fifty-year career of umpiring, designating Congress as its successor. The question remains, however, will Congress accept the appointment or will it remain a spectator?

Joseph P. Paonessa

FEDERAL ESTATE TAXATION—RETAINED LIFE ESTATE—§ 2036—WHEN A SETTLOR TRANSFERS STOCK OF A CLOSELY HELD CONCERN INTO AN INTER-VIVOS TRUST RETAINING VOTING RIGHTS, THE STOCK IS NOT INCLUDIBLE UNDER §§ 2036(a) (1) AND (2) EVEN THOUGH THE SETTLOR RETAINS VOTING CONTROL OF THE CORPORATION.—Under a trust agreement dated December 9,

106 *See* Justice Marshall's dissent, 40 U.S.L.W. at 4756-57. For recent cases in which the Supreme Court has applied the prospective relief concept, see *Simpson v. Union Oil Co.*, 377 U.S. 13, 24-25 (1964), 396 U.S. 13, 14 (1969) where the Court stated that when a newly decided rule is "innovative" and individuals may have justifiably relied upon prior rulings, a federal court may fashion partially prospective relief when the plaintiff establishes a cause of action. In *United States v. Estate of Donnelly*, 397 U.S. 286, 295 (1970) the Court noted that "in rare cases, decisions construing federal statutes might be denied full retroactive effect, as for instance where this Court overrules its own construction of a statute. . . ." *See also* Desist v. United States, 394 U.S. 244 (1969) (criminal law) and City of Phoenix v. Kolodziejski, 399 U.S. 204 (1970) (constitutional law).

107 40 U.S.L.W. at 4754.

108 *Id.*

109 Brief for Respondents at 17.

110 118 CONG. REC. 10149 (1972) (reprint of article by Tom Dowling).

111 40 U.S.L.W. at 4755. *See* recent development in N.Y. Times, Nov. 9, 1972, at 61, cols. 1-6 (city ed.) in which Judge A. Leon Higginbotham of the United States District Court for the Eastern District of Pennsylvania ruled that the National Hockey League was temporarily restrained from enforcing its reserve clause to prohibit players from switching to the World Hockey Association.

1958, Mr. Milliken C. Byrum created an irrevocable trust to which he transferred shares of voting common stock in three closely held corporations. The trust was established for the benefit of his three children and if any of the children died before the termination of the trust, for their surviving children. The sole trustee was an independent corporation, Huntington National Bank of Columbus, Ohio. Under the trust terms, Byrum could vote the shares of unlisted stock held by the trust, approve investments and reinvestments, disapprove the sale or transfer of any trust assets, and remove the trustee and appoint a successor. Byrum continued to vote at least 71% of the outstanding voting stock in each of the three corporations, counting his personally retained stock along with the retained voting rights of the transferred stock.[1]

The Commissioner of Internal Revenue determined that the transferred stock was includible in the decedent's gross estate under section 2036 of the Internal Revenue Code[2] because the right to vote the transferred shares and to veto any sale of the shares by the trustee, together with the ownership of the other shares, enabled Byrum to retain the right to benefit economically from the transferred shares and also allowed him to determine the flow of dividend income and thereby shift or defer the beneficial enjoyment of the income by the trust beneficiaries. Mariam A. Byrum, as executrix, paid an additional estate tax of $13,202.45, and then brought a refund action in the district court. As the facts were not in dispute, both the executrix and the Government moved for a summary judgment. The court granted the executrix' motion.[3] On appeal a three-judge panel of the Court of Appeals for the Sixth Circuit affirmed, with one judge dissenting.[4] The Government's petition for certiorari was granted. The Supreme Court, in a 6-3 decision, affirmed and *held:* Byrum's de facto "control" through the retention of broad management powers, subject as it was to economic and legal constraints, was not tantamount to the "right to designate" the persons who shall enjoy the trust income within the meaning of § 2036(a)(2); nor was Byrum's retention of voting control a retention of the enjoyment of the trans-

1 The actual proportions were:

	Percentage Owned by Decedent	Percentage Owned by Trust	Total Percentage Owned by Decedent and Trust
Byrum Lithographing Co., Inc.	59	12	71
Graphic Realty, Inc.	35	48	83
Bychrome Co.	42	46	88

United States v. Byrum, 92 S. Ct. 2382, 2387 n.2 (1972).

2 INT. REV. CODE OF 1954, § 2036(a) provides:

"*Transfers with retained life estate*

"*(a) General Rule.*—The value of the gross estate shall include the value of all property to the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, under which he has retained for his life or for any period not ascertainable without reference to his death or for any period which does not in fact end before his death—

"(1) the possession or enjoyment of, or the right to the income from, the property, or

"(2) the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom."

3 Byrum v. United States, 311 F. Supp. 892 (S.D. Ohio 1970).

4 Byrum v. United States, 440 F.2d 949 (6th Cir. 1971).

ferred property within the meaning of § 2036(a)(1). *United States v. Byrum,* 92 S. Ct. 2382 (1972).

The immediate holding in *Byrum* is very narrow. Retention of voting control in a closely held corporation, by retaining the voting rights to stock transferred by inter-vivos trust will not result in the stock's being included in the settlor's gross estate under § 2036(a) because of legal and economic constraints as to the use or abuse of this position by the settlor and because the retention of this position itself is not within the encompassment of the phrase "possession or enjoyment." As a consequence the select few, who are in control of a closely held concern and who can afford to relinquish the income from part of their stock and its value as borrowing collateral, can "save" money by removing that stock from the highest estate tax rate bracket applicable to their gross estate and in its stead pay the lower gift tax rate,[5] utilizing where available their lifetime exemption[6] and the annual per donee exclusion.[7] In the instant case, Byrum's estate planning enabled him to decrease his estate tax liability on stock valued at $89,000.00 by $13,202.45.

A. The Reliance Argument

Of more far-reaching impact is the approach taken by the Court in dealing with the Code provision. Speaking for the majority, Justice Powell indicated the direction the Court would take when he wrote: "At the outset we observe that this Court has never held that trust property must be included in a settlor's gross estate solely because the settlor retained the power to manage trust assets."[8] Reliance for this statement is on *Reineche v. Northern Trust Co.*,[9] a 1929 Supreme Court decision, and *Estate of Willard v. King,*[10] a 1962 unappealed Tax Court decision. Several lower court decisions which upheld a settlor-trustee's right to exercise managerial powers without incurring estate tax liability are also referred to by the Court.[11] Justice Powell went on to equate the powers retained by Byrum with the managerial powers retained in *Northern Trust* and in *King* and set forth a reliance argument. The substance of this argument was that hundreds of settlors "may have relied upon" *Northern Trust* in retaining broad powers of management when drafting their trust instruments. The Court is reluctant to part from what it feels is a "generally accepted" interpretation of the tax law which "could have potentially far-reaching consequences."[12]

The minority of the Court was highly critical of the emphasis placed on

5 INT. REV. CODE OF 1954, § 2502(a). The gift tax rate is three-fourths of the estate tax rate.
6 INT. REV. CODE OF 1954, § 2521.
7 INT. REV. CODE OF 1954, § 2503(b).
8 92 S. Ct. at 2388.
9 278 U.S. 339 (1929).
10 37 T.C. 973 (1962), *nonacquiesced in,* 1963-1 CUM. BULL. 5.
11 Estate of C. Dudley Wilson, 13 T.C. 869 (1949), *aff'd,* 187 F.2d 145 (3d Cir. 1951); United States v. Powell, 307 F.2d 821 (10th Cir. 1962); Estate of Willard V. King, 37 T.C. 973 (1962); Estate of Marvin L. Pardee, 49 T.C. 140 (1967); Estate of Ralph Budd, 49 T.C. 468 (1968); Estate of Edward E. Ford, 53 T.C. 114 (1969), *aff'd,* 450 F.2d 878 (2d Cir. 1971); Old Colony Trust Co. v. United States, 423 F.2d 601 (1st Cir. 1970).
12 92 S. Ct. at 2389.

Northern Trust and thought the reliance argument of the majority was unwarranted. It was argued that the approach taken by the majority, that "what appears to be established"[13] should become established, if widely accepted, would frustrate judicial and administrative efforts at present rationalization of the law. Under such an approach neither the tax bar nor the Government could afford to leave a case unappealed for fear of later application of this reliance doctrine.

Speaking for the dissent, Justice White disputes whether there was any sound basis for such a "generally accepted" interpretation of the tax law. The state of the law at the time the instrument was drafted appears at best to have been uncertain. *Northern Trust* was decided over two years before the first version of § 2036(a)(2) was enacted. Reliance on this decision is made even more questionable by the fact that *Northern Trust* is the "elder sibling"[14] of *May v. Heiner*.[15] *May* quoted *Northern Trust* at great length in its treatment of the death tax. It is significant that it was *May*'s restrictive interpretation of the estate tax which prompted Congress to enact § 2036 (a)(2).

Reliance upon lower court decisions, if there was such reliance, also appears unwarranted. In all of the lower court decisions, except *King*, which was decided four years after Byrum's trust instrument was created, the management powers were retained by a settlor-trustee. It should have been apparent to Byrum that the estate plan he was constructing was quite different and that there was a risk in deviating as to the manner of retention. In the lower court decisions, the presence of fiduciary obligations applicable to the settlor as trustee was clearly the determining factor.[16]

Further evidence of the uncertainty of this "general rule" at the time of the creation of Byrum's trust is also available. In *State Street Trust Co. v. United States*,[17] the Court of Appeals for the First Circuit held that several broad management powers taken as a whole were not sufficiently limited by general fiduciary duties under Massachusetts law and therefore required the inclusion of the trust assets under § 2036(a)(2). The impact of this decision was indicated in several leading tax articles[18] which recognized the uncertainty of the state of the law and warned of the risk of inclusion, unless such powers were resigned. Although these considerations clearly show the weakness of the reliance argument, this was not the Court's only justification for holding the trust assets excludible.

B. "Power" versus "Right"

The Government contended that the Court's prior decision in *United States v. O'Malley*[19] compelled the inclusion in Byrum's gross estate of the stock trans-

13 *Id.* at 2404.
14 *Id.*
15 281 U.S. 238 (1930).
16 1 CCH FED. EST. & GIFT TAX REP. ¶ 1461.055 (1971).
17 263 F.2d 635 (1st Cir. 1959).
18 Pedrick, *Grantor Powers and Estate Taxation: The Tie That Binds*, 54 NW. U.L. REV. 527 (1959); Gray and Covey, *State Street—A Case Study of Sections 2036(a)(2) and 2038*, 15 TAX L. REV. 75 (1959); A.B.A. Comm. on Est. & Tax Planning, *Tax-Wise Drafting of Fiduciary Powers*, 4 TAX CONSELOR'S Q. 333 (1960).
19 383 U.S. 627 (1966).

ferred under § 2036(a)(2). In *O'Malley* the principal and accumulated income of the settlor's trust were included in his gross estate under § 2036(a)(2) because the settlor retained the right as a trustee, along with two other trustees, to either pay income to the life beneficiaries or to accumulate it as part of the principal. This power to deny to the beneficiaries the privilege of immediate enjoyment and to condition their eventual enjoyment upon surviving the termination of the trust was deemed to be the right to "designate" within the meaning of the predecessor of § 2036(a)(2), § 811(c) of the 1939 Code. The Commissioner in *Byrum* contended that through the use of his position as majority stockholder, the settlor could influence dividend policy thereby shifting or deferring the beneficial enjoyment of trust income. The Court agreed that Byrum's power came within the meaning of "designate," but made a distinction between a "power" and a "right" to designate.

The Court noted that the term "right" when used in a tax statute must be given its "normal and customary meaning," that is, it must be "ascertainable and legally enforceable."[20] The term "right," asserted the Court, implies the absence of restraints. When restraints are present, the mere existence of a power, as here, to regulate the flow of dividends to a trust, is not sufficient to constitute a "right." The Court did not attempt to justify this restrictive approach, but proceeded immediately to apply it to the facts of this case.

Although Byrum had the "right" to vote the shares held in trust, he only had a "power" to affect dividend policy because of existing economic and fiduciary constraints upon him. As majority stockholder he was subject to state-imposed fiduciary duties which prevented him from using his position to the detriment of minority stockholders. The directors, whom he would have to influence, since they alone controlled dividend policy, were also subject to fiduciary duties. Finally, certain business and economic variables over which Byrum had little control restricted the ability of a small, closely held concern to vary its dividend policy to any great extent.

In drawing this fine line of distinction the Court in effect limited the scope of § 2036(a)(2) to *directly* retained enforceable rights. If the reservation is an *indirect* one subject to restraints, the Court has held it is not within the specific statutory language of § 2036(a)(2). This distinction is one between what could properly be labeled distribution powers and administrative or managerial powers.

This distinction is unwarranted. The circumstances of the statute's passage, its legislative history, the Treasury Regulation interpreting its coverage and the statutory language of the other three estate tax provisions dealing with inter-vivos transfers point to a broad rather than a narrow interpretation. Section 2036(a)(2) was passed by both Houses of Congress on the last day of the session.[21] Only two brief sections of the Congressional Record have any substantial reference to the bill and they comprise the total legislative history of the bill since there was no printed committee report.[22] This limited legislative history indicates that the intent of Congress was to prevent evasion of the estate tax and

20 92 S. Ct. at 2390.
21 H.R.J. Res. 529. 71st Cong., 3d Sess., 46 Stat. 1516 (1931).
22 74 CONG. REC. 7198 (1931).

undermines the specious distinction used by the majority to limit the provision. It appears that the term "right" was used to *expand* the provision to include instances where a decedent had a right to income but did not actually receive it. The right-power distinction is repugnant to congressional intent in limiting rather than expanding its reach.

The Treasury Regulations for both the 1939 and 1954 Internal Revenue Code use the term "power" rather than "right" in explaining the coverage of this statutory section.[23] The Court completely ignored this long-standing interpretation. It should be noted, too, that sections 2035,[24] 2037[25] and 2038,[26] which together with § 2036 comprise all the statutory provisions in the estate tax area dealing with inter-vivos transfers, all use the term "power" rather than "right." These considerations further indicate that Congress intended a broader interpretation of § 2036(a)(2) than that adopted by the Court. In the language of Justice White, "I see no warrant for reading the words in a niggardly way."[27]

The noninclusion of the trust assets in Byrum's gross estate merely because his power over the trust was subject to legal and economic restraints is not a new approach and should be warmly familiar to estate planners. It is the same reasoning several lower courts have used in holding excludable certain managerial or administrative powers of a settlor-trustee. These cases deal mainly with the right to allocate receipts and disbursements between trust income and principal and the power to invest in "non-legals"[28] in conjunction with the power to sell and exchange trust assets. Because the settlor had retained such powers as settlor-trustee or because he had not specifically excluded himself from becoming a successor trustee, the Government sought the inclusion of the trust assets in the settlor's gross estate under § 2036(a)(2). Representative of the feeling of the lower courts in this situation is the following passage from the opinion of Judge Featherston in *Estate of Marvin L. Pardee*:

> Similarly the power, "to allocate receipts and expenditures between income and principal accounts," we believe, was intended merely to give the trustee some discretion so that he would not be required to seek court guidance in making doubtful allocations or run personal liability risks. It was a power which was to be exercised reasonably and in good faith, subject to equity court review for an abuse of discretion.[29]

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23 Treas. Reg. 105, § 81.19, T.D. 5834, 1951-1 Cum. Bull. 72, provides in part: (c) The rights of designation in section 811(c)(1)(B) includes a reserved *power* to designate . . . . (Emphasis added.)

Treas. Reg. § 20.2036-1(b)(3) similarly provides: The phrase "right . . . to designate the person or persons who shall possess or enjoy the tranferred property or the income therefrom" includes a reserved *power* to designate . . . . (Emphasis added.)

24 INT. REV. CODE OF 1954, § 2035 deals with transactions made "in contemplation of death."

25 INT. REV. CODE OF 1954, § 2037 provides for the inclusion of reversionary interests.

26 INT. REV. CODE OF 1954, § 2038 concerns revocable transfers and requires inclusion where the transferor has retained a power to alter, amend, revoke or terminate. Section 2038 overlaps somewhat in its coverage with § 2036(a)(2) and is frequently used as an alternate ground for the inclusion of trust assets by the Government.

27 92 S. Ct. at 2402.

28 Non-legals are investments not classified under a particular state law or ruling of the pertinent court as legal investments for trust funds. Estate of Edward E. Ford, 53 T.C. 114, 128 (1969).

29 49 T.C. 140, 146 (1967).

Typically, the lower courts have excluded the trust assets because they have found under state law that certain fiduciary duties were imposed upon the trustee which were enforceable by a beneficiary in a court of equity. Thus the lower courts have looked to the type of restrictions on the settlor's power as trustee rather than penalizing him for the retention of management powers which are usually included in the boiler-plate of a trust agreement. This approach was adopted by the majority in the *Byrum* case.

Although most of the lower court cases have held that such management powers do not result in estate tax consequences,[30] there remained some controversy as to whether such powers would result in inclusion of the trust assets in a decedent's gross estate. The *State Street* decision and its contribution to the uncertainty in this area have already been mentioned above in connection with the reliance question. In *Old Colony Trust Co. v. United States*,[31] a 1970 decision, the Court of Appeals for the First Circuit reconsidered its holding in *State Street*. After holding the trust assets includible in the settlor's gross estate because of the retention of a right to withhold income if the settlor deemed it in the beneficiary's "best interest," the court, in dicta, indicated that no aggregation of purely administrative powers would cause the inclusion of the trust assets in the settlor's gross estate. This reversal of position brought about some clarification and set the stage for the *Byrum* decision.

By labeling Byrum's retained rights as management powers, by recognizing and applying a reliance argument as to the non-taxibility of management powers, and by restricting the application of § 2036(a)(2) by means of its "right" versus "power" distinction, the Supreme Court has ended the controversy over whether management powers will place trust assets in the settlor's gross estate. Not only did the Court utilize the reasoning of the lower courts in looking to the quality of the power reserved, but it also found justification for it in the statutory language of § 2036(a)(2) itself. The Court in *Byrum* indicates that only in cases where an ascertainable and legally enforceable "right" to "designate" amounting to a directly retained distribution power exists will § 2036(a)(2) apply. In light of Byrum, it is inconceivable that a management power alone will be sufficient for the inclusion of a trust corpus in a decedent's gross estate under § 2036(a)(2).

C. Possession or Enjoyment

The Government also sought inclusion of the trust assets under § 2036(a)(1) arguing that by retaining control Byrum guaranteed himself continued employment and remuneration and also the right to force a liquidation or merger, so that he had retained for his life the right of "enjoyment." In rejecting this contention, the Court emphasized that the specific statutory language of § 2036(a)(1) contemplates a retention of an attribute of the transferred property itself. More specifically, Byrum's personally retained shares are to be excluded in looking to see if control was actually transferred. The majority would thus

30 *Supra*, note 11.
31 423 F.2d 601 (1st Cir. 1970).

require the settlor to transfer the controlling interest in the stock to the trust before it would allow the control argument to be made.

Even if a controlling interest had been transferred, the Court indicated it would still not have required inclusion because the benefits retained were not within the well-settled connotation of "enjoy" or "enjoyment" applicable to estate tax statutes. In other words, Byrum had not retained a "substantial present economic benefit."[32] The power to force a liquidation or merger is a "speculative and contingent" benefit and therefore not a "present"[33] one. Nor did the guaranty of continued employment and compensation constitute "possession or enjoyment" because the Court felt that it was not substantial. In appraising its value, the Court noted that a dominant stockholder, if "active and productive,"[34] is likely to hold a senior position anyway and that there are constraints upon the use of his influence, such as the disallowance of a deduction for unreasonable compensation by the Internal Revenue Service and the possibility of a suit by minority interests for a violation of his duty as an officer to act in the best interests of the corporation.

Restricting the scope of "possession or enjoyment" through the use of a strict interpretation of "substantial present economic benefit" is in direct contrast to the prior use of those terms by the Court. Citing *Commissioner v. Estate of Holmes*[35] the majority states that:

> It is well settled that the terms "enjoy" and "enjoyment," as used in various estate tax statutes, are not terms of art, but connote substantial present economic benefit rather than technical vesting of title or estates.[36]

It is important to note that in the *Holmes* case this definition was utilized to expand the application of "enjoyment" rather than to limit it. In *Holmes* the Court used this test to reject an argument made by the taxpayer based on the technical vesting of title.

The exact issue presented in *Byrum,* whether retention of voting control of a closed corporation alone would result in estate tax liability, had never before been considered by the Supreme Court. Only one unreported 1968 lower court case has considered this exact issue. In *Yeazel v. Coyle,*[37] the United States District Court for the Northern District of Illinois used the "substantial present economic benefit" test of *Holmes* to limit the application of § 2036(a)(1), but held the trust assets includible under § 2035. The Supreme Court in *Byrum* adopted the approach of *Yeazel* as a method of preventing includibility under § 2036(a)(1).

In treating this specific issue for the first time, the Supreme Court should not have felt confined by its earlier decisions dealing with the scope of "possession or enjoyment." These prior decisions did not necessarily delineate the outer limits of the coverage of this provision.

32 92 S. Ct. at 2395.
33 *Id.* at 2397.
34 *Id.*
35 326 U.S. 480 (1946).
36 92 S. Ct. at 2395.
37 68-1 U.S. Tax Cas. 87,384 (1968).

A more expansive approach had, in fact, been taken by the Supreme Court. In 1949, the Supreme Court in *Commissioner v. Estate of Church*[38] spent a considerable portion of its opinion tracing the history, use, and meaning of the phrase "possession and enjoyment" as Congress had used and intended it in several death tax statutes since 1862. Although dealing with the reservation of the right to income by a settlor, the Court did not restrict itself to "substantial present economic benefit," but took a broad, common-sense approach which it considered to be consistent with the congressional purpose behind the use of the "possession or enjoyment" clause, that it, "to frustrate estate tax evasion."[39]

Justice White, in the dissenting opinion, advanced the approach of the *Church* opinion as controlling and quoted the portion of the *Church* opinion interpreting the "possession or enjoyment" language:

> [A]n estate tax cannot be avoided by any trust transfer except by a bona fide transfer in which the settlor, absolutely, unequivocally, irrevocably, and without possible reservations, parts with all of his title and all of his possession and all of his enjoyment of the transferred property.[40]

As recently as 1966 the Court approved this practical approach by requiring a complete transfer to avoid taxability.[41]

In *Byrum* the Court completely ignored the *Church* decision and instead relied upon the definition of "enjoyment" given in *Holmes* to restrict the coverage of § 2036(a)(1). In the process, the Court refused to look beyond a direct retention of legally enforceable rights to an indirect retention which in actuality could represent a substantial benefit to the grantor.

The Supreme Court departed from both the legislative intent of Congress and the Court's own approach in its prior decisions. Instead it chose to adopt and develop the approach of several lower court decisions by the use of an unwarranted, strained, legalistic approach.

D. Conclusion

This approach is reminiscent of the Court's decision in *May*[42] and its progeny[43] where life estates were held not includible in the decedents' gross estate where the settlor passed bare legal title before his death. The only practical alternative is the same one that was available and used after *May*—legislative action. In drafting such legislation, Congress should first re-evaluate the goals and purposes of both the estate and gift taxes. *Byrum* illustrates the inherent inequality of the present separate estate and gift tax scheme which has developed out of piecemeal legislation. The inequality of the present system lies in the fact that only those people who can afford to make lifetime transfers after providing

38 335 U.S. 632 (1949).
39 *Id.* at 638; *accord,* Estate of Spiegel v. Commissioner, 335 U.S. 701, 706 (1949).
40 *Id.* at 645.
41 United States v. O'Malley, 383 U.S. 627, 631 (1966).
42 *Supra,* note 15.
43 *See* Burnet v. Northern Trust Co., 283 U.S. 782 (1931); Morsman v. Burnet, 283 U.S. 783 (1931); McCormick v. Burnet, 283 U.S. 784 (1931).

for their own future financial needs are able to fully take advantage of the lower gift tax rates as well as its $30,000.00 lifetime exemption and $3,000.00 annual per donee exclusion. Under the approach of the Court in *Byrum*, the trust corpus will not be included in the gross estate as long as neither a distribution power nor a *direct* economic benefit, such as income or use of the property, is retained by the settlor. *Byrum* has limited the decision that a prospective settlor and his estate planner must make to a purely financial one, for the settlor need only give up these *direct* benefits to avoid federal estate taxes.

A Unified Transfer Tax[44] may be the only solution to this inherent inequity. A Unified Transfer Tax with a single progressive rate scale for both inter-vivos and testamentary transfers and a single exemption available for the settlor's first transfers, whenever made, would result in an equal imposition of the tax burden upon all taxpayers, regardless of their financial position. The existing preferential gift tax rate and lifetime exemption provide a loophole, available only to those financially able to take advantage of it.

Thomas L. Poscharsky

GOVERNMENT CONTRACTS—GOVERNMENT DOES NOT HAVE THE RIGHT TO SEEK JUDICIAL REVIEW OF AN UNFAVORABLE ADMINISTRATIVE DECISION ON A CONTRACT CLAIM—On August 4, 1961, S & E Contractors, Inc., contracted with the Atomic Energy Commission (AEC) to build a testing facility at the National Reactor Test Station in Idaho. Because of various specification changes and difficulties in meeting performance deadlines, S & E submitted a series of claims to the contracting officer for resolution under the standard disputes clause,[1] requesting equitable modifications of the contract and additional compensation. Certain claims which were decided adversely to the contractor were seasonably appealed to the AEC. Since the AEC had not yet established a contract appeals board, it referred the appeal to a hearing examiner before whom an adversary hearing was held. The hearing examiner decided in favor of eight of S & E's claims and remanded the dispute to the contracting officer for settlement of the exact amount to be paid to S & E. Contrary to this directive, the contracting officer then sought review of the examiner's decision by the AEC. The AEC reversed the hearing examiner on one claim, modified three and declined to review four of the claims which had the effect of sustaining the hearing examiner's determinations on those claims. Among the claims the AEC refused to review was the examiner's decision that amounts due S & E could not be retained to offset claims allegedly owed by the contractor to other contractors and governmental agencies. The Commission then remanded the dispute to the contracting officer with instructions to proceed to final settlement in accordance with the determinations of the hearing examiner as modified by its decision.

On March 6, 1964, prior to the AEC's final ruling but after it had upheld

44 *See A.L.I.*, FEDERAL ESTATE AND GIFT TAX PROJECT (Study Draft No. 1, 1965; Study Draft No. 2, 1966; Problems and Recommendations 1968); *see also* C. Shoup, FEDERAL ESTATE AND GIFT TAXES (1966).

1 The clause reads as follows:

the examiner's decision on the retainage claim, an AEC certifying officer requested the opinion of the General Accounting Office (GAO) on whether a voucher for the retainage claim could be certified for payment. After 33 months of review, the Comptroller General concluded that the voucher could not be certified. Despite the narrowness of the certifying officer's request, the GAO advised the AEC that payment on any of the disputed claims would be improper because the AEC's findings as to those claims were not supported by substantial evidence and were erroneous on matters of law. The AEC then informed S & E that it would take no further action inconsistent with the views expressed by the Comptroller General. S & E initiated an action in the Court of Claims seeking a money judgment of $1.95 million and an order remanding the case for negotiations on the time extension which it claimed was granted under the AEC's original decision. The Department of Justice defended the suit on the ground that the AEC's decision was not supported by substantial evidence and was erroneous on questions of law.

The Court of Claims ruled in favor of the Government, reasoning that the Wunderlich Act[2] was determinative of the issue[3] and that it allowed both the Government and contractors equal rights to judicial review of administrative decisions under the disputes clause.[4] The court further concluded that the AEC's refusal to follow the hearing examiner's decision was a permissible means of obtaining judicial review.[5] On appeal, the Supreme Court *held*: 1. The AEC, which for the purpose of the contract was the United States, had exclusive administrative authority under the disputes clause procedure to resolve the disputes at issue, and neither the contract between the parties nor the Wunderlich Act permitted still further administrative review by the GAO. 2. The Wunderlich Act does not confer upon the Department of Justice the right to appeal an administrative disputes decision. 3. Although the Wunderlich Act denies finality to any administrative decision that is "fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence," it was not intended to confer equal rights on contractors and

6. *Disputes*
(a) Except as otherwise provided in this contract, any dispute concerning a question of fact arising under this contract which is not disposed of by agreement shall be decided by the Contracting Officer, who shall reduce his decision to writing and mail or otherwise furnish a copy thereof to the Contractor. The decision of the Contracting Officer shall be final and conclusive unless, within 30 days from the date of receipt of such copy, the Contractor mails or otherwise furnishes to the Contracting Officer a written appeal addressed to the Commission. The decision of the Commission or its duly authorized representative for the determination of such appeals shall be final and conclusive unless determined by a court of competent jurisdiction to have been fraudulent, or capricious, or arbitrary, or so grossly erroneous as necessarily to imply bad faith, or not supported by substantial evidence. In connection with any appeal proceeding under this clause, the Contractor shall be afforded an opportunity to be heard and to offer evidence in support of its appeal. Pending final decision of a dispute hereunder, the Contractor shall proceed diligently with the performance of the contract and in accordance with the Contracting Officer's decision.
(b) This "Disputes" Clause does not preclude consideration of law questions in connection with decisions provided for in paragraph (a) above; Provided, that nothing in this contract shall be construed as making final the decision of any administrative official, representative, or board on a question of law. S & E Contractors, Inc. v. United States, 406 U.S. 1, 3-4 n. 2 (1972).

2 41 U.S.C. §§ 321, 322 (1970).
3 S & E Contractors, Inc. v. United States, 433 F.2d 1373, 1375 (Ct. Cl. 1970).
4 *Id.* at 1378.
5 *Id.* at 1378-79.

the Government to challenge decisions on the stated grounds, but was intended to confer such rights only on contractors. *S & E Contractors v. United States*, 406 U.S. 1 (1972).

I. Historical Sketch of the Scope of Judicial Review in Government Contracts

A. *Before the Wunderlich Act*

Prior to the enactment of the Wunderlich Act in 1954, disputes clauses in government contracts provided that administrative decisions made by a designated government official were final and conclusive.[6] In other words, the terms of these clauses precluded all judicial review whether it was sought by the Government or by the contractors. In 1878 the Supreme Court fashioned exceptions to the finality of administrative decisions made under disputes clauses in *Kihlberg v. United States*:

> [I]n the absence of fraud or such gross mistake as would necessarily imply bad faith, or a failure to exercise an honest judgment, his [the government official's] action in the premises is conclusive upon the appellant [contractor] as well as upon the government.[7]

In later cases this rule was applied to settlement provisions in both government[8] and private[9] contracts without regard to which party challenged the finality of the decision.[10]

In recent years the Court of Claims has given the exceptions enunciated in *Kihlberg* an expansive interpretation.[11] In 1951 the Supreme Court stopped this trend toward broadening the scope of judicial review and, in fact, reversed it in *United States v. Wunderlich*[12] by holding that any administrative decision made pursuant to a disputes clause is final and conclusive on both parties unless the challenging party alleges and proves that the government official rendering the decision acted fraudulently.[13] The Court explicitly defined fraud to mean

6 *See* Kihlberg v. United States, 97 U.S. 398 (1878); United States v. Gleason, 175 U.S. 588 (1900); Ripley v. United States, 223 U.S. 695 (1912); United States v. Mason & Hanger Co., 260 U.S. 323 (1922); United States v. Moorman, 338 U.S. 457 (1950); United States v. Wunderlich, 342 U.S. 98 (1951).

7 97 U.S. 398, 402 (1878).

8 Sweeney v. United States, 109 U.S. 618 (1883); United States v. Gleason, 175 U.S. 588 (1900); Ripley v. United States, 223 U.S. 695 (1912); United States v. Moorman, 338 U.S. 457 (1950); Merrill-Ruckgaber Co. v. United States, 241 U.S. 387 (1916); United States v. Mason & Hanger Co., 260 U.S. 323 (1922); Goltra v. Weeks, 271 U.S. 536 (1926).

9 Martinsburg & Potomac R.R. v. March, 114 U.S. 549 (1885); Chicago, S.F., and Cal. R.R. v. Price, 138 U.S. 185 (1891); Sheffield & Birmingham Coal, Iron & Ry. v. Gordon, 151 U.S. 285 (1894).

10 Chicago, S.F. and Cal. R.R. v. Price, 138 U.S. 185 (1891); United States v. Mason & Hanger Co., 260 U.S. 323 (1922).

11 *See* B-W Constr. Co. v. United States, 97 Ct. Cl. 92, 123 (1942); Needles v. United States, 101 Ct. Cl. 535 (1944); Mitchell Canneries v. United States, 77 F. Supp. 498, 502 (Ct. Cl. 1948); Penner Installation Corp. v. United States, 116 Ct. Cl. 550, 564 (1950).

12 342 U.S. 98 (1951).

13 *Id.* at 100.

"conscious wrongdoing, an intention to cheat or be dishonest."[14] Justice Minton, writing for the majority, stated:

> The limitation upon this arbitral process is fraud, placed there by this Court. If the standard of fraud that we adhere to is too limited, that is a matter for Congress.[15]

Indeed, this narrow definition of fraud alarmed both the Government and contractors for it had the practical effect of denying virtually all judicial review of administrative decisions made under a disputes clause.

B. *The Wunderlich Act*

The legislative response to this decision took the form of the so-called Wunderlich Act[16] which was enacted in 1954. It expressly overruled the holding of the Wunderlich case by providing that no provision of any contract entered into by the United States relating to finality or conclusiveness of any decision of an administrative official or board shall be pleaded in any suit as limiting judicial review to cases where fraud by such official or board is alleged.[17] The Act then set the bounds of the scope of judicial review by providing that "any such decision shall be final and conclusive unless the same is fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence."[18] Finally, it provided that no administrative determination on a question of law shall be assigned finality.[19]

C. *After the Wunderlich Act*

Until the holding of *S & E Contractors v. United States*, it was thought that the right to judicial review mandated by the Wunderlich Act was equally applicable to contractors and the Government.[20] This assumption was quite understandable in light of the statute's legislative history,[21] its language[22] and a number of Court of Claims cases[23] which have implied that the Government has a right to judicial review by actually overturning administrative determinations favorable to contractors. This view was reinforced in 1965 when the Court of

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14 *Id.*
15 *Id.*
16 41 U.S.C. §§ 321, 322 (1970).
17 41 U.S.C. § 321 (1970).
18 *Id.*
19 41 U.S.C. § 322 (1970).
20 Kipps, *The Right of the Government to Have Judicial Review of a Board of Contract Appeals Decision Made Under the Disputes Clause*, 2 PUB. CONTRACT L.J. 286, 287-88, 292 (1969); Ulman, *The Attorney General on Review of Contract Appeals Board Decisions and the GAO*, 2 PUB. CONTRACT L.J. 279, 284 (1969).
21 *See* text accompanying notes 51-63 *infra.*
22 *See* text accompanying note 49 *infra.*
23 Milwaukee Shipbuilding & Eng'r Co. v. United States, 121 F. Supp. 922 (Ct. Cl. 1954); Northrop Aircraft v. United States, 127 F. Supp. 597 (Ct. Cl. 1955); Associated Traders, Inc. v. United States, 169 F. Supp. 502 (Ct. Cl. 1959); Flippin Materials Co. v. United States, 312 F.2d 408 (Ct. Cl. 1963); Copco Steel & Eng'r v. United States, 341 F.2d 590 (Ct. Cl. 1965).

Claims expressly addressed itself to the issue in *C. J. Langenfelder & Son, Inc. v. United States*[24] saying:

> [The contractor-plaintiff] is in effect asking that we read into all government contracts (with Disputes clauses) the provision that a claim otherwise properly before the court may not be decided on the merits if there was a prior administrative determination favorable to the contractor, *i.e.*, a clause that administrative determinations for the contractor are automatically conclusive. The standard Disputes clause does not and cannot now contain such a limitation, because the Wunderlich Act specifically prohibits the inclusion in a government contract of any clause making the decisions of an administrative official on questions of law *or* fact completely final and free from judicial review [citation omitted]. The Act, phrased in universal terms, *makes no qualification or exception for administrative orders sustaining the contractor.*[25] (Emphasis added.)

II. Holding of *S & E Contractors v. United States*

The Court's holding in *S & E Contractors* can be best summarized by dividing it into the three conclusions reached by the Court.

A. *GAO's Lack of Authority*

The Court reasoned that if the Comptroller General's action was characterized as review of the AEC's decision or even as an action designed to obtain judicial review for the Government, nevertheless it was a form of "additional administrative oversight" which was foreclosed by the disputes clause procedure and not provided for by any Act of Congress including the Wunderlich Act.[26]

The approach taken by the majority was that under the contract the disputes clause sets forth the exclusive administrative means for resolving contractual disputes. Under that clause the AEC was the final administrative arbiter of such claims, and nowhere was there provision for oversight by the Comptroller General.[27] No reasoning was given by the Court to substantiate its decision that the Wunderlich Act failed to provide an administrative review by the GAO.

B. *Department of Justice's Lack of Authority*

The Court next decided that although the Attorney General has the duty to "conduct . . . litigations in which the United States, an agency or officer thereof is a party," it is not clear that such power gives the Department of Justice the right to appeal from a decision of the AEC.[28] The Court concluded that:

> Normally, where the responsibility for rendering a decision is vested in a co-

24 341 F.2d 600 (Ct. Cl. 1965).
25 *Id.* at 607. Later in *Acme Process Equip. Co. v. United States,* 347 F.2d 538 (Ct. Cl. 1965), the Court of Claims reaffirmed its decision in *Langenfelder.*
26 406 U.S. 1, 9, 12 (1972).
27 *Id.* at 12.
28 *Id.* at 12-13.

ordinate branch of Government, the duty of the Department of Justice is to implement that decision and not to repudiate it.[29]

C. *Unilateral Review Under the Wunderlich Act*

The Court also concluded that although the Wunderlich Act denies finality to any administrative disputes decision that is "fraudulent or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence,"[30] the Act does not confer on the Government the right to challenge administrative decisions of contract disputes on the stated grounds, but was intended to confer that right only on contractors.[31] No clear justification was given by the majority for this conclusion. Indeed, there was a noticeable absence of any analysis of the statutory language of the Act or its legislative history. It appears that the Court was simply implementing what it considered to be an overriding public policy. At the risk of oversimplifying this policy and understating its significance, it may be summarized as follows:

When a contractor enters into a contract with the United States, he must submit to the Government's prescribed arbitral system of resolving controversies arising under the contract. When he does this, he agrees to "proceed diligently with the performance of the contract."[32] This means that he effectively waives his common law right to suspend work and sue for breach or defend suit on the ground the other party has rescinded the contract.[33] The effect of this is to place the financial burden of any directed changes of performance, unanticipated difficulties, or additional work which may arise during performance on the contractor.[34] As a reasonable *quid pro quo* the contractor is entitled to the assurance that when he secures from a designated board a final decision in his favor, that decision will not be attacked by the Government.[35]

III. Analysis

The majority believed that the GAO lacked authority to review administrative disputes decisions and to withhold payment thereon because such intervention was not provided for in either the standard disputes clause or in any Act of Congress including the Wunderlich Act. Not only is this assertion without sup-

29 *Id.* at 13.
30 41 U.S.C. § 321.
31 406 U.S. 1, 13-15 (1972).
32 *Id.* at 8.
33 *Id.* at 8, 20 (concurring opinion).
34 *Id.* at 19. Justice Blackmun, concurring, stated in part:

> The issue is not whether advantage is or is not to be taken of the Government. Of course, the Government's rights are to be protected. That protection, however, is afforded by the nature and workings of the contract disputes system, by its emphasis on expeditious performance and getting the job done, and by the presence of the contracting officer and the agency, but not of the GAO. This results in fulfillment of the contract and, at the same time, gives the contractor the protection he needs against fraud, capriciousness, arbitrariness, bad faith, and absence of evidence. In the exercise of its legislative judgment, Congress has determined that in this area the Government needs no more.

Id. at 23.
35 *Id.* at 14.

port, but one of the major reasons for passage of the Wunderlich Act was to assure to the General Accounting Office a limited right of scrutiny of disputes decisions.

Traditionally the GAO's only power has been the power of the purse.[36] In numerous government contract disputes the Comptroller General has reviewed disputes decisions, disagreed with their correctness, and withheld payment or deducted amounts already paid from amounts owing to the contractor.[37] While the courts have held that the GAO's view of the correctness of a disputes decision does not bind the courts,[38] the GAO has had the power to force the contractor to bring suit, thereby obtaining judicial review for the Government.[39] The Supreme Court, however, in *United States v. Wunderlich,* held that decisions under the disputes clause were final unless fraud was alleged and proved. After that decision the Comptroller General conceded that his powers of review had for all practical purposes been eliminated.[40] As a result, the GAO in its role as congressional watchdog of the public purse, having an overriding interest in all government contracts, played a prominent role throughout the course of the Wunderlich Act legislation. In fact, the GAO's consent to enactment of the legislation was made conditional on the inclusion of some explicit legislative history in order to preserve GAO's prerogatives in this area.[41] The Committee report that accompanied the bill stated that:

> The proposed legislation, as amended, will not add to, narrow, restrict, or change in any way the present jurisdiction of the General Accounting Office either in the course of a settlement or upon audit, and the language used is not intended either to change the jurisdiction of the General Accounting Office or to grant any new jurisdiction, but simply to recognize the jurisdiction which the General Accounting Office already has.
>
> The elimination of the specific mention of the General Accounting Office from the provisions of the bill as amended should not be construed as taking away any of the jurisdiction of that Office. *It is intended that the General Accounting Office, as was its practice, in reviewing a contract and change orders for the purpose of payment, shall apply the standards of review that are granted to the courts under this bill. At the same time there is no intention of setting up the General Accounting Office as a "court of claims."* Nor should the elimination of the specific mention of the General Accounting Office in the bill be construed as limiting its review to the fraud-

36 *See* 31 U.S.C. §§ 71, 74 (1970) (GAO's authority to settle and audit accounts).

37 United States v. Mason & Hanger Co., 260 U.S. 323 (1922); Penn Bridge Co. v. United States, 59 Ct. Cl. 892 (1924); Albina Marine Iron Works v. United States, 79 Ct. Cl. 714 (1934); McShain Co. v. United States, 83 Ct. Cl. 405 (1936); B-W Constr. Co. v. United States, 97 Ct. Cl. 92 (1942); Associated Traders, Inc. v. United States, 169 F. Supp. 502 (Ct. Cl. 1959).

38 United States v. Mason & Hanger Co., 260 U.S. 323, 326 (1922); James Graham Mfg. Co. v. United States, 91 F. Supp. 715, 716 (N.D. Cal. 1950); Penn Bridge Co. v. United States, 59 Ct. Cl. 892, 896 (1924); Eaton, Brown & Simpson, Inc. v. United States, 62 Ct. Cl. 668, 685 (1926); McShain Co. v. United States, 83 Ct. Cl. 405, 409 (1936).

39 *See* cases cited note 37 *supra.*

40 *See Hearings on S. 2487 Before a Subcomm. of the Senate Comm. on the Judiciary,* 82d Cong., 2d Sess. 5-7 (1952).

41 Schultz, *Wunderlich Revisited: New Limits on Judicial Review of Administrative Determination of Government Contract Disputes,* 29 LAW & CONTEMP. PROB. 115, 132 (1964).

> ulent intent standard prescribed by the Wunderlich decision.[42] (Emphasis added.)

The Court's finding that no GAO role was provided for in the Wunderlich Act ignores the statute's legislative history.

The Court next turned to the Department of Justice's involvement in the case and attacked that office's authority as well.

> That power [the Department of Justice's power to defend suits against the United States] is pervasive but it does not appear how under the Wunderlich Act it gives the Department of Justice the *right to appeal* from a decision of the Atomic Energy Commission.[43] (Emphasis added.)

The fallacy of this reasoning is that the Court dealt with whether the Department of Justice had the right to appeal, when the real issue was whether the Department of Justice had the authority to defend a lawsuit brought against the United States as a result of the GAO's refusal to certify payment on a disputes decision. If the Court was merely careless with its language and in fact meant to say that the Department of Justice lacks the authority to defend a suit brought by a contractor to enforce a favorable disputes decision, then one is hard-pressed to find any such qualification in the statutory provisions[44] which confer the aforementioned "pervasive authority" on the Department of Justice. In fact, judicial history shows that the Department of Justice has exercised the same type of authority for years.[45] Justice Brennan aptly described the Court's reasoning in his dissent:

> The notion that Congress enacted the Wunderlich Act to abolish the authority of GAO and the Department of Justice is completely a figment of the Court's own imagination. As the judicial history shows, both agencies have exercised for decades powers identical to those exercised in this case, with no prior complaints, . . . and with complete congressional approval.[46]

The central question presented to the Court was whether the Wunderlich Act affords the Government the right to obtain judicial review of decisions of

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42 H.R. REP. No. 1380, 83d Cong., 2d Sess. 6-7 (1954).

43 406 U.S. 1, 12-13 (1972).

44 28 U.S.C., §§ 516, 519 (1970). Section 516 provides in full:

> Except as otherwise authorized by law, the conduct of litigation in which the United States, an agency, or officer thereof is a party, or is interested, and securing evidence therefor, is reserved to officers of the Department of Justice, under the direction of the Attorney General.

Section 519 provides in full:

> Except as otherwise authorized by law, the Attorney General shall supervise all litigation in which the United States, an agency, or officer thereof is a party, and shall direct all United States attorneys, assistant United States attorneys, and special attorneys appointed under Section 543 of this title in the discharge of their respective duties.

45 *See, e.g.*, Yale & Towne Mfg. Co. v. United States, 58 Ct. Cl. 633 (1923); Penn Bridge Co. v. United States, 59 Ct. Cl. 892 (1924); Albina Marine Iron Works v. United States, 79 Ct. Cl. 714 (1934); McShain Co. v. United States, 83 Ct. Cl. 405 (1936); Northrop Aircraft, Inc. v. United States, 127 F. Supp. 597 (Ct. Cl. 1955); Associated Traders, Inc. v. United States, 169 F. Supp. 502 (Ct. Cl. 1959).

46 406 U.S. 1, 63 (1972) (dissenting opinion).

administrative tribunals unfavorable to it on contract claims made in the course of the standard disputes procedure. The Court held that no such right was conferred upon the Government by the Wunderlich Act.[47] As has already been indicated, the Court gave little reasoning for this holding except for numerous references to a policy of equity designed to prevent "vexatious litigation."[48] This interpretation of the Wunderlich Act is not only shortsighted, but it is also inconsistent with the clear mandate of Congress.

Section 1 of the Wunderlich Act provides:

> No provision of any contract entered into by the United States, relating to the finality or conclusiveness of any decision of the head of any department or agency or his duly authorized representative or board in a dispute involving a question arising under such contract, shall be pleaded in any suit now filed or to be filed as limiting judicial review of any such decision to cases where fraud by such official or his said representative or board is alleged: *Provided, however,* That *any* such decision shall be final and conclusive *unless* the same is fradulent [*sic*] or capricious or arbitrary or so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence.[49] (Emphasis added.)

The language of this provision makes no reference or qualification as to *who* may seek judicial review; rather, it deals with the *scope* of judicial review, and it states a general rule which applies to "any" administrative decision made pursuant to a government contract alleged to fall within one of the five enumerated categories. Justice Brennan recognized the focus of the statutory language when he said:

> It is impossible to read the plain words of this statute as directing that judicial review is available only for disputes decisions unfavorable to contractors. Indeed, the language is so clear that there should be no need to search through the legislative history for a contrary meaning. That history, in any event, demonstrates that the Act means exactly what it says.[50]

The bill first submitted in the Senate, which received the most attention, was negative in approach and language.[51] Its purpose and effect were confined to the express overruling of the *Wunderlich* case. Because the restrictions imposed by *Wunderlich* applied with equal force to the Government as well as contractors, the GAO became concerned with the proposed legislation, so much so that the

47 *Id.* at 13-15.
48 *Id.* at 8.
49 41 U.S.C. § 321 (1970).
50 406 U.S. 1, 58 (1972) (dissenting opinion).
51 *Hearings on S. 2487 Before a Subcomm. of the Senate Comm. on the Judiciary,* 82d Cong., 2d Sess. 7 (1952). This bill provided:

> That no provision of any contract entered into by the United States, relating to the finality or conclusiveness of any decision of the Government contracting officer, or of the head of the department or agency of the United States concerned or his representative, in a dispute involving a question of fact arising under such contract, shall be construed to limit judicial review of any such decision only to cases in which fraud by such Government contracting officer or such head of department or agency or his representative is alleged.

Comptroller General submitted a substitute bill[52] which served a twofold purpose. First, it expressly overruled *Wunderlich* as had its predecessor and, second, it affirmatively set out five grounds upon which an appeal of a disputes decision could be based, *i.e.*, when a decision is fraudulent, capricious, arbitrary, so grossly erroneous as necessarily to imply bad faith, or is not supported by substantial evidence.[53]

When the Comptroller General's bill was introduced into the Senate of the Eighty-Third Congress, Senator McCarran, the bill's sponsor, observed:

> Senators who have looked into this matter know that this decision [the *Wunderlich* decision] cuts two ways. *It can hurt the Government badly,* as well as doing an injustice to contractors. In a recent case [*Leeds & Northrup Co. v. United States*],[54] which arose since this Supreme Court decision, the Government did in fact lose. . . . There had been an honest mistake by a contracting officer. The Comptroller General of the United States attempted to recover on behalf of the Government, because the mistake was against the Government. The contractor interposed a defense based on the Supreme Court decision in the Wunderlich case. The Court followed the Supreme Court decision—as it was bound to do—and the result was a failure of recovery on behalf of the Government.[55] (Emphasis added.)

Senator McCarran later stated on the Senate floor that:

> [T]his interpretation [the *Wunderlich* holding] can operate greatly to the disadvantage of contractors, in cases where there has been a gross mistake against the interest of the contractor. *It is equally true that, to the same extent, this interpretation can operate to the disadvantage of the Government. . . .*[56] (Emphasis added.)

Thus, Senator McCarran, the *sponsor* of the bill, as well as the GAO, the *author* of the bill, recognized the bilateral impact the Wunderlich Act was intended to have. The Comptroller General's bill passed the Senate with the obvious understanding that the expanded scope of judicial review provided would be available to both contractors and the Government. The bill was then forwarded to the House for consideration.

The House passed a modified version of this bill omitting specific mention of the GAO.[57] The reason for this omission was that many contractors felt that the phrasing of the language of the Senate bill would set up the GAO as another

52 *Id.* at 7. The substitute bill which the Comptroller General recommended provided that:

> No Government contract shall contain a provision making final on a question of law the decision of an administrative official, representative, or board. Any stipulation in a Government contract to the effect that disputed questions shall be finally determined by an administrative official, representative or board shall not be treated as binding if the General Accounting Office or a court finds that the action of such officer, representative or board is fraudulent, arbitrary, capricious, grossly erroneous, or that it is not supported by substantial evidence.

53 *Id.*
54 101 F. Supp. 999 (E.D. Pa. 1951).
55 99 CONG. REC. 4573 (1953) (remarks of Senator McCarran).
56 *Id.* at 6170.
57 100 CONG. REC. 5510 (1954).

Court of Claims,[58] and they argued that "an agency of the legislative branch . . . should not be used to perform functions intended for the judicial branch."[59]

After passage in the House and submission of the modified bill to the Senate, the Comptroller General expressed complete satisfaction with the House language and declared that it accomplished the same purposes sought to be served in his earlier bill.[60] It was further established on the floor of the Senate immediately prior to passage that the modified bill had the precise legislative effect as the GAO's original bill.[61] The Senate then passed the modified bill which was later to be called the Wunderlich Act.[62]

The importance of this historical sketch is that neither bill gave any indication that the expanded scope of judicial review was to be available only to contractors. On the contrary, the Government was the author of the bill. It is absurd to suppose that the Government first submitted and then pressed for passage of a bill that, on the one hand, grants contractors an expanded right of judicial review and, on the other, deprives the Government of any judicial review whatsoever.

Further support for the proposition that no such one-sided judicial review was contemplated by Congress is found in House Report No. 1380:

> After extensive hearings it has been concluded that it is *neither to the interests of the Government nor to the interests of any of the industry groups that are engaged in the performance of Government contracts* to repose in Government officials such unbridled power of finally determining either disputed questions of law or disputed questions of fact arising under Government contracts, nor is the situation presently created by the Wunderlich decision consonant with tradition that *everyone* should have his day in court and that contracts should be mutually enforceable.[63] (Emphasis added.)

It appears from the Court's decision in *S & E Contractors* that it refused to be bound by the clear and unambiguous legislative history and statutory language of the legislation which it had a duty to interpret.

IV. Conclusion

The Court's construction of the Wunderlich Act has a dual impact which is detrimental to both parties.

A. *Effect on the Government*

Two significant anomalies result from interpreting the Wunderlich Act as providing judicial review only to contractors. First, the Court's interpretation is in direct conflict with the Act's flat prohibition of making disputes decisions final

58 *See Hearings on H.R. 1839 Before Subcomm. No. 1 of the House Comm. on the Judiciary*, 83d Cong., 1st & 2d Sess. 22-30 (1953-54).
59 *Id.* at 26.
60 100 CONG. REC. 5717 (1954) (remarks of Senator McCarran).
61 *Id.* at 5718.
62 *Id.*
63 H.R. REP. No. 1380, 83d Cong., 2d Sess. 4 (1954).

on questions of law.[64] Section 2 of the Wunderlich Act provides:

> No Government contract shall contain a provision making final on a question of law the decision of any administrative official, representative, or board.[65]

Presumably, if finality may not be expressly imputed to administrative decisions on matters of law by way of specific provision in the contract, it cannot be imputed without such provision. Yet the denial of any judicial review to the Government means that when a Government official or board decides in favor of a contractor on a question of law, that administrative decision will be final. Therefore, the Court's statutory interpretation creates an internal inconsistency within the Act.

Justice Brennan pointed out a second anomalous result which illustrates even more graphically the absurdity of the Court's interpretation:

> [W]hen the Government argeed to a disputes clause with no provision for judicial review, it could nevertheless challenge the finality of a disputes decision at least for fraud [under *Wunderlich*], but now that the Government has agreed to a disputes clause specifying five grounds of judicial review, including fraud, it is entitled, holds the Court, to none at all.[66]

B. *Effect on Contractors*

Though an argument can be made for the equitable result achieved by the Court's decision in this particular case, the Court's concern for the fair treatment of contractors was shortsighted and misplaced.

By attributing finality to decisions made by administrative appeal boards the Wunderlich Act implies an expectation that these boards will enjoy a degree of independence and impartiality comparable to that of other quasi-judicial boards.[67] As a result, a number of government agencies have attempted to infuse into their appeal boards highly qualified individuals for the purpose of establishing truly impartial tribunals.[68] Consequently, the ultimate effect of binding only one party, namely the Government, to a decision of one of these tribunals will be to violate the integrity of that tribunal. It will behoove the Government to be less concerned with the quasi-judicial qualifications of those appointed to the board than with having individuals appointed who will be subservient to the Government's interests. Judge Nichols of the Court of Claims observed:

> The temptation either to appoint persons to the Board who would be subservient to management wishes, or to make improper *ex parte* approaches,

64 406 U.S. 1, 30-31 (1972) (dissenting opinion).
65 41 U.S.C. § 322 (1954).
66 406 U.S. 1, 30 (1972) (dissenting opinion).
67 S & E Contractors, Inc. v. United States, 433 F.2d 1373, 1379-80 (Ct. Cl. 1970).
68 The Armed Services Board of Contract Appeals, 32 C.F.R. § 30.1 (1972), and the General Services Aministration Board of Contract Appeals, 41 C.F.R. § 5-60.102 (1972), are made up entirely of qualified attorneys admitted to the bar.

> would be near to impossible to resist. Within the four walls of an executive establishment, the real independence of a Board would be suspect, the facts as to this would be difficult to come by, and contractors could never be sure they were getting from disputes clause procedures what they had contracted for. On the other hand, if the [Government] has the right to seek review within Wunderlich Act limitations, there is a safety valve and Boards can call cases as they see them without so much pressure building up.[69]

The net result of the Court's decision, which was intended to mitigate the possible financial burden to which contractors are subjected, will be to exacerbate the problem by forcing contractors to appeal far more decisions than they have had to in the past. Certainly this was not the intent of Congress in passing the Wunderlich Act.

Brian W. Ruddell

LIABILITY OF CERTIFIED PUBLIC ACCOUNTANTS—UNAUDITED FINANCIAL STATEMENTS—CERTIFIED PUBLIC ACCOUNTANTS ARE LIABLE FOR NEGLIGENCE IN PREPARATION OF UNAUDITED STATEMENTS.—Max Rothenburg & Company, a certified public accounting firm, was employed by an incorporated apartment cooperative owned by its own shareholder-tenants but managed by a real estate management firm, Riker & Co. The contract of employment between the cooperative and the Rothenburg firm called not for an audit, but rather for preparation of unaudited financial statements. Nevertheless, when the accountant failed to detect the fraud of the real estate management firm, the apartment cooperative brought suit claiming both breach of contract and negligence. In supporting the cooperative's claim, the New York Court of Appeals *held*: certified public accountants are liable for services performed in preparation of unaudited financial statements. *1136 Tenants' Corporation v. Max Rothenburg & Company,* 30 N.Y.2d 585, 281 N.E.2d 846, 330 N.Y.S.2d 800 (1972).

Prior to the *Rothenburg* decision, Certified Public Accountants were held liable only for negligence in rendering a professional audit in which an opinion was issued. While the scope of the accountant's liability for negligence in audited statements has expanded over the years,[1] the courts have not previously extended such liability to other areas of accounting service. The *Rothenburg* case, however, extended such liability to services which fall short of a full-scale audit. Though it is not yet clear what the precedential value of the case will be, the New York courts may have opened the door to full liability for negligence in the performance of any accounting service.

As manager of the cooperative, Riker & Co. made collections for the cooperative and deposited them in its own account. It was also obligated to pay the bills of the cooperative and to render monthly reports. This the management firm failed to do. Although it rendered monthly reports these reports were falsified since many of the bills were not paid. The defendant accountants merely com-

69 S & E Contractors, Inc. v. United States, 433 F. 2d 1373, 1380 (Ct. Cl. 1970).

1 *See,* Note, *Public Accountants and Attorneys: Negligence and the Third Party,* 47 NOTRE DAME LAWYER 588 (1972).

piled the reports without examination and prepared financial statements with which they included a transmittal letter stating:

> [W]e have reviewed and summarized the statements of your managing agent and other data submitted to us by Riker & Co., Inc. pertaining to 1136 Tenants' Corporation. . . .
>
> The following statements [the financial statements and appended schedules] were prepared from the books and records of the Corporation. No independent verifications were undertaken. . . .[2]

All pages of the financial statements were marked with an inscription that they were subject to the transmittal letter.

The trial court held that the accountant had undertaken to perform an audit. Further, it stated that even if there was no agreement for an audit, in which case it would be an engagement for write-up work only, a fraud such as this should have been detected.[3] The court concluded "that whether the scope of the defendant's retainer agreement with the plaintiff was to perform a 'write-up' or an 'audit', certain definitive auditing procedures were necessitated and mandated under this oral retainer."[4] The court thus found that the defendant was guilty of both breach of contract to perform an audit and negligence in the performance of its work. The appellate division[5] and court of appeals summarily affirmed. Both courts placed great emphasis on the fact that some auditing procedures had in fact been performed.

There is substantial evidence to suggest that the lower court was incorrect in its interpretation of the accountant's contract. In the appellate division the dissenting opinion by Justice Steuer clearly demonstrated that the defendant was not hired to perform an audit.[6] The Justice candidly pointed out that "[i]t is hardly credible that an embezzler would engage an accountant to make an audit which would immediately reveal his own peculations."[7] Additional support is lent to this view by the fact that not once did the defendant maintain that an audit would not have revealed the fraud.[8] Moreover, Justice Steuer continued:

> [T]he proof unequivocally shows that the statements issued by all the accountants hired by Riker (defendants and those that preceded them in the job) bore legends to the effect that they were unverified and no independent examination had been made.[9]

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2 Letters of transmittal from Max Rothenburg & Co. to 1136 Tenants' Corp., 1964, reproduced in Brief for the New York State Society of Certified Public Accountants and the American Institute of Certified Public Accountants as Amicus Curiae as published in *"AICPA-NYSCPA Brief in 1136 Tenants' Corporation Case,"* THE JOURNAL OF ACCOUNTANCY 58 (March 1971) [hereinafter cited as Brief].

3 1136 Tenants' Corp. v. Max Rothenburg & Co., No. 10575/1965 (June 16, 1970).

4 *Id.*

5 1136 Tenants' Corp. v. Max Rothenburg & Co., 36 App. Div. 2d 804, 319 N.Y.S.2d 1007 (1971).

6 *Id.* at 804, 319 N.Y.S.2d at 1008.

7 *Id.* at 805, 319 N.Y.S.2d at 1009.

8 Brief, *supra* note 2, at 58.

9 36 App. Div. 2d at 805, 319 N.Y.S.2d at 1009.

The dissent adopted the position of the American Institute of Certified Public Accountants (A.I.C.P.A.) that "the best evidence of what the parties agreed that the accountants should do was the work product that they tendered."[10] This was potent evidence of what the agreement was.[11] Further support for this position is supplied by Statement on Auditing Procedure No. 33, which provides that when an audit is made an opinion as to the correctness of the statements must be rendered.[12]

Justice Steuer went on to point out that the fee paid was hardly commensurate with the work and responsibility of an audit.[13] While the trial court felt this argument was self-serving and without merit, at least one court has held that the fee is some evidence of the scope of the work agreed upon.[14] Since an accountant, of all people, would certainly endeavor to provide his service at a profit, a small fee should alert a reasonable man that a complete audit will not be performed. Had all the justices taken as close a look at the factual circumstances as did Justice Steuer they would have found that only unaudited financial statements had been contracted for.

If the trial court had limited its decision to the questions of fact concerning the scope of the accountant's engagement the accounting profession would have no reason to be concerned. However, the court's own opinion indicated that it failed to understand the difference between audited and unaudited financial statements. The trial judge expressed the opinion that certain auditing procedures are required in any "write-up" engagement.[15] At the same time he concluded that "a certified public accountant can make an examination which constitutes an audit without making independent verifications."[16] Both of these positions are clearly in error.

By its very nature an unaudited financial statement does not require auditing procedures. In the statements of the accounting profession, a financial statement is unaudited if no audit procedures are applied. Only procedures insufficient to allow the accountant to express an opinion are used.[17] The purpose of an unaudited statement is to provide guidance and advice on accounting procedure and presentation while not subjecting the client to the large cost of an unnecessary audit. Many smaller clients simply do not need audits yet they do need a great deal of help and advice.

The responsibility which the accountant takes for unaudited financial statements is minimal. The accounting profession specifically recognizes that "the certified public accountant has no responsibility to apply any auditing procedures to unaudited financial statements,"[18] and even if the accountant should decide to apply some audit procedures he should be liable only for the services agreed

10 Brief, *supra* note 2, at 58.
11 36 App. Div. 2d at 805, 319 N.Y.S.2d at 1009.
12 A.I.C.P.A. COMM. ON AUDITING PROCEDURE, STATEMENT No. 33 at 56 (1963) [hereinafter cited as STATEMENT No. 33].
13 36 App. Div. 2d at 805, 319 N.Y.S.2d at 1009.
14 Ronaldson v. Moss Watkins, Inc., 127 So. 467, 470 (La. 1936).
15 No. 10575/1965.
16 *Id.*
17 A.I.C.P.A. COMM. ON AUDITING PROCEDURE, STATEMENT No. 38 at 53-4 (1967) [hereinafter cited as STATEMENT No. 38].
18 *Id.* at 54.

upon.[19] It is only when the accountant actually knows of material error or fraud[20] or believes statements to be false or misleading that duties are required.[21] In such a situation, he must refuse to associate himself with the statements.[22] The sole duty of the accountant for unaudited financial statements is to prevent misinterpretation of the degree of responsibility that he took in preparing them.

On the other hand, audited financial statements are those in which a C.P.A. expresses an opinion after he has performed his analysis. Since the C.P.A. is required to express an opinion as to fairness of the statement an audit has become synonymous with independent verifications.[23] It is in audited financial statements that a much higher degree of care is required because the public will rely upon the opinion as to the fairness in accord with generally accepted accounting principles. In the true sense an audit is not possible without verifications.

Perhaps a more disturbing fact is the issue on which the appellate division rested its affirmance of the case.[24] The appellate division attributed great significance to the fact that the defendant had actually performed some auditing procedures, which indicated "suspicious circumstances."[25] However, such emphasis is unfounded. Failure to complete these procedures is not negligence because a lack of professional care cannot be imputed to failure to perform something which has never been promised.[26]

The major problem with this fact situation is that some invoices were in fact missing. This led the trial court (with whom the appellate court agreed) to state that the accountant should have detected the defalcations.[27] However, the standards of the accounting profession require only that the accountant disclose material error and/or fraud known to him,[28] or that he refuse to be associated with statements which he believes to be misleading.[29] The appellate court has substituted a test of suspiciousness for these standards of the profession.

Missing invoices are a rather common problem in the course of an audit. In the case of a small concern which usually has poor procedures to begin with, missing invoices are simply not enough to alert an accountant or put him on guard for fraud. They are often simply misplaced or lost with no reason to suspect any wrongdoing.

Ordinarily, the standards of reasonable care which apply to public accountants are the same as those applied to other professional men.[30] Accordingly, their professional conduct should be judged according to their professional standards.[31] While it is perfectly proper for courts to re-evaluate professional standards

19 *See* Kurland, *Accountants' Legal Liability Ultramares to BarChris,* 25 BUS. LAW. 155 (1969). *See also* Annot., 54 A.L.R.2d 324 (1957).
20 STATEMENT No. 33, *supra* note 12, at 60.
21 STATEMENT No. 38, *supra* note 17, at 55.
22 *Id.*
23 Brief, *supra* note 2, at 61.
24 36 App. Div. 2d at 804, 319 N.Y.S.2d at 1007.
25 *Id.* at 804, 319 N.Y.S.2d at 1008.
26 *See* note 19 *supra.*
27 10575/1965.
28 STATEMENT No. 38, *supra* note 17, at 55.
29 *Id.*
30 Gammel v. Ernst & Ernst, 245 Minn. 249, 253, 72 N.W.2d 364, 367 (1955).
31 *Id. See also* Hawkins, *Professional Negligence Liability of Public Accountants,* 12 VAND. L. REV. 797 (1959).

when they consider them inadequate,[32] it should be done only when they are unreasonable. Here the court has departed from that long-established rule of professional conduct. With no explanation of why the standards were insufficient, the court simply changed them.

Admittedly, *Rothenburg* is a difficult case because of the actual facts involved. It is not unreasonable to require that an accountant who uncovers missing invoices totaling $44,000.00 at least inform the client, and perhaps the court felt that these accountants were just too unreasonable. But, as difficult as the facts are, the holding is in error. The courts of New York now appear to demand the same degree of care and responsibility for unaudited financial statements as for those which are audited.

The court may well have been prompted by a desire to protect those who rely upon financial statements. If the New York Court follows its ruling, however, it may well have an opposite effect. The holding could eliminate what is known as an unaudited financial statement from the services offered by Certified Public Accountants because of the expense and potential liability involved. Since too many small companies can neither afford nor need an audited statement they will be compelled to employ professional help less often.

With liability for all professionals expanding rapidly, one cannot be certain what direction the courts will take under the *Rothenburg* rationale. There have been a number of suggestions as to how the problems of the case may be avoided. Further, there are a number of positions on how accountants must perform in order to live within the most strict interpretations of the case. Following is a short summary of some opinions on how an accountant can avoid liability in light of the *Rothenburg* decision.

One of the first and most obvious problems with the engagement was that it was based upon an oral contract of hiring.[33] A written contract or engagement memorandum could very well have turned the case.[34] Where the services to be performed are sharply defined, it would be difficult for a court to decide that because a defendant needs an audit that must have been what he contracted for.[35]

Additionally, care must be taken to see that the unaudited statements rendered by an accountant are not misused. As an increasing number of courts require greater responsibility on the part of accountants, it is possible that an accountant could be deemed "associated" with financial statements within the meaning of the Statement on Auditing Procedure No. 33 for:

1. Mailing statements to a third party in an envelope which carries the C.P.A.'s return address.
2. Conversations between the C.P.A. and a third party with respect to the accounting work performed or the content of the financial statements.

32 *See generally* W. PROSSER, THE LAW OF TORTS 161-65 (4th ed. 1971).
33 10575/1965.
34 Touche, Ross, Bailey & Smart, The Rothenburg Case, A warning to the profession 6/21/71 (unpublished memorandum on file with the *Notre Dame Lawyer*).
35 10575/1965.

3. Mailing statements with a transmittal letter on the C.P.A.'s stationery.
4. Situations where the third party merely knows of or is told the name of the C.P.A. who prepared them.[36]

While at the present time this would seem quite unrealistic, an accountant could be held negligent for a failure to foresee the effects of this association. Therefore, he should put the public on notice by disclaimer of opinion on any unaudited financial statements with which he is in any way associated.[37] In addition, each and every page should contain the inscription "unaudited." This alone might have avoided the problems in the *Rothenburg* case.

Any auditing procedures which are to be taken in a non-audit engagement should be spelled out in an engagement memo with an explanation of their purpose. Only these procedures should be taken. Since the court in *Rothenburg* criticized the accountant for not following up the missing invoices,[38] all auditing procedures undertaken should be completed.[39] If all procedures are spelled out, including their reason and limitation and then fully executed to the extent required by the engagement memorandum, a court should require no more.

The most difficult problem for the C.P.A. associated with unaudited statements is what to do once he encounters suspicious circumstances. The fundamental question raised here is whether, as a practical matter, the recognition of "suspicious circumstances" would be sufficiently easy for the average practitioner.[40] The trial court itself suggests that the accountant must report what he has discovered to the client. It further implies that the accountant must also take what he has discovered into account in the preparation of financial statements.[41] This could be either in the form of a disclosure or a special form of disclaimer.[42] Finally, the court suggests additional audit procedures to resolve the problem.[43] While none of these represent an unreasonable approach and would certainly free the accountant of liability, the basic problem of recognition remains. Little guidance or comfort can be offered to the average C.P.A., because the New York courts have imposed a new standard, "suspiciousness," which does not fit within the accountant's traditional framework. The court is requiring him to subject his client to the embarrassment of a disclaimer and disclosure, or the added expense of additional audit procedures on mere suspicion, not facts or even reasonable belief.

The trial court, appellate division and court of appeals all seemed to focus on different points as the predicate for their decision. Nevertheless, all indicate a setback for a profession which has ardently endeavored to establish high standards of professional competence. One problem might be that the *Rothenburg*

36 *The C.P.A.'s Responsibility for Unaudited Financial Statements,* THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT 89, 89-92 (Feb. 1965).
37 STATEMENT No. 38, *supra* note 17, at 54-5.
38 10575/1965.
39 Touche, Ross, Bailey & Smart, *supra* note 34.
40 Covington & Burling, Memorandum of Counsel to A.I.C.P.A. Board of Directors, Committee on Accountants' Legal Liability 4/23/71 (unpublished memorandum on file with the *Notre Dame Lawyer*).
41 *Id.* at 5.
42 *Id.*
43 *Id.* at 6.

accountants had few standards to follow when their services were performed.[44] However, those standards were clearly available at the time of trial. Based upon the facts of the case what the trial court has required may not be unreasonable, but the manner in which they chose to present their decision could have a long-lasting negative effect of requiring the same standard of care in unaudited financial statements as is required in the preparation of audited financial statements.

Hopefully, the decision in the case reflects only the facts of a particular "hard" case. Nonetheless, the New York courts should critically examine all future cases of this type and re-establish the standards of the accounting profession as the accepted measure of negligence. On the other hand, the accounting profession must provide clearer guidelines for its practitioners and establish the standards necessary to avoid liability for services not involving a full-scale audit.

Michael J. Whaling

44 Statements 33 and 38 both call for action on the part of an accountant only when he has actual knowledge as a fact or a reasonable belief that there is fraud or a material misstatement. STATEMENT No. 33, *supra* note 12, at 60; STATEMENT No. 38, *supra* note 17, at 55.

MISSING AND UNKNOWN HEIRS LOCATED

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