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NOTES

THE DISENCHANTED CLIENT V. THE DISHONEST LAWYER: WHERE DOES THE LEGAL PROFESSION STAND?

I. Introduction

A recent edition of the Buffalo Evening News featured a story headlined "ATTORNEY'S NAME TAKEN OFF ROLLS." Underneath this startling caption, the article announced:

[An attorney] admitted to the state bar in 1939, was charged with 10 counts of unprofessional conduct, according to the Appellate Division. Later he was found to be mentally ill and suspended from law practice Feb. 25, 1963, the court said.

The misconduct charges included accusations of misappropriation of trust funds, commingling of trust funds of clients with his own funds, fraud, forgery and aiding and abetting unauthorized persons to practice law.¹

The court accepted the attorney's resignation and ordered his name stricken from the rolls of the practicing bar; but what becomes of the claims of clients who have suffered a financial loss as a result of this type of alleged misconduct? Had the misappropriation been perpetrated by a banker, the FDIC surely would have come forth to reimburse the aggrieved depositor. Where, however, a like deed is committed by a member of the legal profession, the client receives no compensation in almost half our states.²

II. The Problem

When an attorney misappropriates the funds or property of a client and the client's civil remedies are of no avail in restoring his loss, he and the general public look next to the legal profession for satisfaction. In some instances the profession reacts by imposing disciplinary measures, possibly even disbarment, upon the offending attorney. Unfortunately this does little to satisfy the client or generate public esteem for the profession.³

Undeniably, the bar has shown a great responsibility and dedication to the interests of the public through its regulation of admission to the bar. This is a meaningful and worthwhile effort to insure that those members of the legal profession who hold themselves out to the public as competent and trustworthy

1 Buffalo Evening News, Sept. 23, 1966, p. 48, col. 6.

2 Of course compensation for any loss suffered may be had if the client successfully pursues the civil remedies available in an action against the offending attorney or his estate. But this is little consolation when the attorney is judgment proof, dead, or his whereabouts are unknown. For a list of those states with clients' security funds see Appendix.

3 The most disturbing aspect of such cases is that almost invariably the amounts embezzled are relatively small and the financial circumstances of the client are such that the loss may create a significant hardship for him. The usual result is that the client, regardless of the discipline imposed on the lawyer, is left without economic redress. ABA JUNIOR BAR CONFERENCE REPORT ON CLIENTS' SECURITY FUNDS 3 (Spring 1964).

actually are so. Only the requisite education and good moral character will qualify a fledgling applicant to practice law.⁴ The number of yearly disbarments has decreased both in proportion to the total number of lawyers and absolutely.⁵ Nevertheless, few lawyers would controvert the findings of an opinion poll in which the honesty and integrity of lawyers were rated very low by the public.⁶ Indeed this lack of esteem seems to have been the lot of the lawyer throughout history. In 1450 it was said, "The law serveth as naught else in these days but for to do wrong, for nothing is sped but false matter by color of the law for mede, drede and favor."⁷ One of Shakespeare's common men, while musing on what he would do if he were king, put it more forcefully: "The first thing we do, let's kill all the lawyers."⁸

The legal profession is confronted with a residual, often inarticulate absence of respect from many laymen. Lawyer conduct of the type publicized by the Buffalo Evening News serves to crystalize this latent mistrust. It is with this in mind that members of the profession must inquire into whether the profession as a whole is doing all that it should for clients who have been victimized by an unscrupulous attorney. Mr. Theodore Voorhees, of the Pennsylvania Bar, has expressed his views on this problem:

We are engaged in a profession that serves the public and enjoys a monopoly in that service. We rightfully control the machinery governing admission to our privileged ranks and the discipline and disbarment of those who

4 Some would question, however, the efforts of the bar in supervising the integrity, ability, and performance of attorneys once admitted into the profession. Finneson, *Obligations of the Grievance Committee of a Bar Association to the Members of the Bar*, 36 N.Y.S.B.J. 482, 484-85 (1964).

5 Mr. Smith made this statement after compiling yearly figures for disbarment and suspensions from 1955 to 1960. Smith, *Disbarment & Disciplinary Action: The Record for Five Years*, 47 A.B.A.J. 363 (1961). Figures announced by E. Blythe Stason for the period ending August 31, 1962, further bear this out:

| | Dis- barred | Sus- pended | Rein- stated | Re- signed | Total New Penalties |
|-----------------------------------|----------------|----------------|-----------------|---------------|---------------------------|
| September 1, 1955-August 31, 1956 | 56 | 46 | 18 | 16 | 118 |
| September 1, 1956-August 31, 1957 | 65 | 56 | 24 | 18 | 139 |
| September 1, 1957-August 31, 1958 | 52 | 49 | 34 | 35 | 136 |
| September 1, 1958-August 31, 1959 | 81 | 59 | 31 | 39 | 179 |
| September 1, 1959-August 31, 1960 | 78 | 60 | 33 | 26 | 164 |
| September 1, 1960-August 31, 1961 | 75 | 95 | 31 | 40 | 210 |
| September 1, 1961-August 31, 1962 | 74 | 90 | 45 | 45 | 209 |

Stason, *Disbarments & Disciplinary Action: The Record for 1960-1961 & 1961-1962*, 49 A.B.A.J. 270, 272 (1963). There naturally is disagreement as to whether this evidences the preeminent honesty of the profession or a halfhearted and anemic disciplinary system.

6 "A vast majority of laymen have a high regard for their own lawyers. But, a substantial number do not entertain the same regard for lawyers as a professional class." Drinker, *Laymen on the Competency & Integrity of Lawyers*, 22 TENN. L. REV. 371, 377-78 (1952). While the poll, analyzed by H. S. Drinker, was conducted in 1952, there is little reason to suspect that a drastic about-face has occurred in the public's estimation of the lawyer.

The thrust of another survey indicated that lawyers do not enjoy the public respect that their position and function in a democracy would dictate. Blaustein, *What Do Laymen Think of Lawyers? Polls Show the Need for Better Public Relations*, 38 A.B.A.J. 39 (1952).

7 Words of Jack Cade, leader of the Cade Rebellion and later immortalized by Shakespeare. COHEN, *THE LAW: BUSINESS OR PROFESSION?* 26 (rev. ed. 1924).

8 Henry VI, Part II, Act IV, Sc. ii.

transgress The public looks to the profession to keep its own house in order and when a lawyer embezzles his clients' funds, the whole bar is blackened in the public eye. The rest of us, as well as the embezzler, are considered at fault because we have failed to police our own ranks and to prevent the defalcation.

Even if in fact the profession could properly feel without blame, the defrauded client is a casualty whose injury arises out of the practice of our profession.⁹

III. A Clients' Security Fund

Erwin N. Griswold, Dean of the Harvard Law School, more than a decade ago made several proposals to improve the standing of the legal profession in the eyes of the community and at the same time aid it in discharging its public duty.

My first proposal is a fairly simple one. Would it not be a fine thing if local bar associations . . . established an insurance fund, which would guarantee, as a professional and association matter, that no client of a member of the association would suffer loss through the defalcation of his lawyer?¹⁰

In 1955 the American Bar Association constituted a committee to study the feasibility of a program of this type — a clients' security fund.¹¹

A general outline of the function of such a fund is sketched by the State Bar of Arizona.

The purpose, so far as the public is concerned, of such a plan is to provide reimbursement for persons who have had funds embezzled by their attorneys. Payment is not to be made for any other claims made by clients arising out of disputes over fees, claims of errors or omissions, or other items sometimes termed malpractice. It is to cover only voluntary defalcations by attorneys and would, therefore, be somewhat similar to bonds now provided by fiduciaries, banks, escrow agents, etc.

The purpose, as far as members of the State Bar of Arizona are concerned, is twofold: (1) To discharge an obligation or debt of honor, which falls upon our profession by virtue of the fact that our Supreme Court and State Bar govern the qualifications of those permitted to practice law in this state; and (2) To obtain very beneficial publicity at the time any defalcations do occur.¹²

A. The Desirability of a Clients' Security Fund Program

The basic argument in favor of the establishment of a clients' security

9 [Feb. 1959] ABA SPECIAL COMMITTEE ON CLIENTS' SECURITY FUND REP. 3.

10 Address by Dean Griswold, Cleveland Bar Association Meeting, Dec. 9, 1953; also printed in 25 CLEVELAND B.A.J. 39 (1954). It is interesting to note that two other suggestions made by Dean Griswold, legal aid services and criminal defense programs, are very much a reality today. His last suggestion, for improving discipline among members of the bar, has not met with the same rapid success.

11 ABA JUNIOR BAR CONFERENCE REP., *supra* note 3, at 5.

12 Arizona State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE. This questionnaire, concerning clients' security funds, was sent, on September 24, 1966, to over 100 state, local, and foreign law associations. All responses to the questionnaire are on file in the office of the NOTRE DAME LAWYER. Hereinafter it will be referred to as NOTRE DAME LAWYER QUESTIONNAIRE.

fund is premised upon the bar's moral duty to the public. The profession holds itself out to the public as honorable, learned, and skilled; when this trust is betrayed, the profession as a whole has a duty to rectify the wrong committed against a client. The client has relied upon the profession's collective representation. Consequently, the profession has an interest in every breach of that representation.¹³ The cogency of this argument naturally depends upon one's understanding of the nature of the legal profession and the role public service plays in it. Roscoe Pound's noble view of the profession is most persuasive.

[A profession] refers to a group of men pursuing a learned art as a common calling in the spirit of public service — no less a public service because it may incidentally be a means of livelihood. *Pursuit of the learned art in the spirit of a public service is the primary purpose.* Gaining a livelihood is incidental, whereas in a business or trade it is the entire purpose.¹⁴ (Emphasis added.)

Clearly, Pound would have lawyers keep uppermost in their minds their duty to serve the best interests of the public.

Where Pound's injunction has been accepted in its totality, bar associations have undertaken a heretofore unparalleled program. That is, no other group or profession has voluntarily pledged itself, in advance, to rectify the failings of a member through financial restitution of that which has been taken. By recognizing this responsibility, in the absence of any legal duty or public pressure, the bar can fulfill its highest aspirations as a profession.¹⁵

Crime creates headlines; the efficient administration of justice is rarely as eye-catching. An attorney who creates a trust in a craftsman-like manner will not see his name in the newspapers; an attorney who embezzles the funds of that trust most assuredly can expect speedy and widespread notoriety. The bar has suffered from a noticeable lack of imaginative public relations. Self-discipline alone is insufficient to bridge the chasm between the legal profession and the public.

[T]he Bench and the Bar must do more than just clean its own house. They must establish cordial relations with the Press and other modern media of communications. . . . [W]e can demonstrate by our deeds that our profession is honest, able and public-minded, it is in the public interest that the public should be informed of the facts.¹⁶

The only method available to the profession for the creation of goodwill is by doing good deeds that are of public interest. Generally the workaday

13 Indeed, the stake is very high. It may well be that public reliance upon the ability and integrity of the profession is the very backbone of the profession's success. Were public confidence to dip so low that very few would be willing to trust important matters to the profession, it would hurt lawyers' pocketbooks as well as their pride.

14 POUND, *THE LAWYER FROM ANTIQUITY TO MODERN TIMES* 5 (1953). Dean Pound re-emphasized, "This spirit of public service in which the profession of law is and ought to be exercised is a prerequisite of sound administration of justice according to law." *Id.* at 10.

15 [Aug. 1960] ABA SPECIAL COMMITTEE ON CLIENTS' SECURITY FUND REP. J. B. Corbet, of the Alberta Law Society, bears witness to this. "[I]t is a matter of some pride that no client has lost one penny because of the dishonest acts of a lawyer since the plan was instituted." Alberta Law Society reply to NOTRE DAME LAWYER QUESTIONNAIRE.

16 PHILLIPS & MCCOY, *CONDUCT OF JUDGES & LAWYERS* 213 (1952).

activities of the lawyer are not newsworthy, but some action on the part of the profession to counteract the misdeeds of a lawyer might merit attention. A clients' security fund adequately serves this purpose. When the news media proclaim an attorney's misdeed, the onus of this deed would be largely neutralized if the bar could announce immediately that it stood ready to remedy the victim's loss. An Arizona news clipping serves to illustrate this point:

ATTORNEYS REIMBURSE DEFRAUDED WIDOW

A Phoenix widow received \$4,000 from the Clients Security Fund of the State Bar of Arizona to reimburse her for funds misappropriated by an attorney.¹⁷

In this fashion the legal profession is not left defenseless in the face of sensational news of a lawyer's breach of trust.

When called upon to evaluate the British security fund, the Committee Chairman had this to say:

What you all wish to know is whether on the evidence of the past fifteen years the Fund . . . has accomplished its purpose. The answer is an unqualified "yes."

It is so far the most important step the Law Society has taken in the field of public relations . . . and has done more than anything else to enhance the prestige and honor of the profession.¹⁸

Even more recently the Secretary of the New Zealand Law Society stated, "I think that it is universally accepted that the existence of the Fund has been most beneficial to the confidence which the public have reposed in the legal profession."¹⁹

Naturally the success of any public relations effort, based upon a clients' security fund, is contingent on adequate publicity being given to the creation and activities of the fund. The Minnesota State Bar Association approached this goal in an effective manner by distributing this press release to the papers:

STATE LAWYERS AIM TO BETTER PUBLIC IMAGE

The Minnesota State Bar Association Friday adopted two measures "to preserve its professional integrity" and to improve the public image of lawyers. . . .

The fund, which goes into effect next year, will be completely controlled, administered and financed by the Bar Association.²⁰

Not all the bar associations, however, have been as successful in presenting their case to the public. This is evidenced by the fact that several local bar associations, responding to the NOTRE DAME LAWYER QUESTIONNAIRE were unaware of the establishment of funds by either their state bar association or other local bar associations within their state. To the extent that elements of the organized

17 Yuma Daily Sun, Oct. 22, 1964.

18 Brian E. Toland, Esq., of the Law Society of England, cited in ABA JUNIOR BAR CONFERENCE REP., *supra* note 3, at 7.

19 New Zealand Law Society reply to NOTRE DAME LAWYER QUESTIONNAIRE.

20 Minneapolis Morning Tribune, June 29, 1963.

bar, along with presumably the greater part of the general public, remain uninformed of a fund's existence, the fund is not matching its potential for creating goodwill.²¹

In the opinion of Graham L. Sterling, former President of the California Bar Association, another method of creating a favorable public image is by word of mouth. Thus, any client who has been reimbursed from the coffers of a bar's fund can be relied upon to be a lifelong goodwill ambassador for the profession. Indeed, Mr. Sterling sees this as the most significant means of good public relations.²²

A further argument advanced in favor of a clients' security fund may be less important. Essentially it states: a fund to protect clients should be established by the profession before there develops public pressure, with attendant legislation, to do so. Chief Justice C. C. McLaurin of the Alberta Supreme Court has indicated that the Canadian bar was forced to establish their funds in response to political and public pressure.²³ Substantial defalcations by several English solicitors generated similar pressures which resulted in the creation of the English Fund.²⁴ Presently there does not appear to be a movement afoot either in the legislatures, or among the public, to force the establishment of clients' security funds in the United States, nor are there traces of it on the horizon.

B. Militations Against Establishment of a Clients' Security Fund Program

Feelings run high against a clients' security fund on the part of some members of the bar. At the latest meeting of the Oregon State Bar, where a resolution was adopted establishing a fund in Oregon, the Committee's minority dissented vigorously:

Once again, the whole Bar has been falsely indicted, by the exponents of bureaucracy, because of the perfidy of a few lawyers. . . .

The proposal made by a majority of the committee is illusory, impractical and contrary to simple justice. We sincerely believe that if it is adopted such will result in heavy expense, serious difficulty in executing the plan and defeat the dispensing of justice to those who betray a trust reposed in them.²⁵

21 This ignorance in part can be explained by the small number, or total lack, of claims filed with the funds by clients (see Appendix). However, it seems clear that the funds' creation was not adequately publicized in the instances just mentioned.

22 Sterling, *A Clients' Security Fund*, 36 CAL. S.B.J. 957, 958 (1961).

23 ABA JUNIOR BAR CONFERENCE REP., *supra* note 3, at 11.

24 ABA, GUIDE FOR THE ESTABLISHMENT OF CLIENTS' SECURITY FUNDS 6 (3d ed. 1961). The furor in England caused more than just a tarnished reputation for the legal profession. "The loss of public confidence in the solicitors caused many to turn from lawyers and to employ trust departments of banks, accountants and other laymen to do the work which had previously been done by solicitors . . ." *Ibid.*

25 OREGON STATE BAR COMMITTEE REPORTS 20 (1966) (minority report). The dissenters continued:

The adoption of the plan proposed by a majority of the Committee will constitute an admission by the Bar that there are now among us many who cannot be trusted with the money of their clients.

It is our firm belief . . . it will put an end to criminal prosecution of those lawyers who thereafter are guilty of embezzling or misappropriating the money of a client. *Id.* at 21.

The principal argument of those opposing establishment of a fund was summarized by a member of the California State Bar Committee on Clients' Security Fund, Galen McKnight:

We do agree that the legal profession holds itself out to the public as a learned and honorable profession in whose members the public is entitled to have trust and confidence and that in every instance of a lawyer's defalcation the bar as a whole receives public condemnation. We do not believe that this establishes any moral guilt or pecuniary responsibility on the part of the profession as a whole simply because it cannot attain complete perfection in the moral integrity of every one of its members, or that the public will think any more of us as a profession if we assume such guilt by offering pecuniary restitution to every client who has been unfortunate enough to choose a lawyer who did not live up to the standards set by the rest of his profession.²⁶

This position rejects the concept of any moral responsibility on the part of the profession as a whole and denies any public relations benefit to be derived from a clients' security fund. The fund's opponents contend that the public's opinion of the profession will only be as high as the profession's opinion of itself. Therefore, since indemnifying lawyers' misdeeds is an admission of collective guilt, the creation of a fund can only have a deleterious effect on the profession's public image. Furthermore, criminal prosecution and civil redress are sufficient satisfaction for the public. Compensation of clients is not needed; if it were provided for, it might cause laxness on the part of lawyers handling clients' money.²⁷

Theodore Voorhees, a prime mover behind the creation of clients' security funds in the United States, feels the basic resistance to the funds is the reluctance to appropriate money for them.²⁸ In fairness it must be noted that the Funds' critics are not without constructive suggestions to meet the problem of lawyer misconduct. They do insist that greater efforts should be made to more carefully screen admissions to the bar and in policing and disciplining its members.²⁹ The merit of these proposals is inescapable.

IV. The International Experience

Any consideration of clients' security funds would be deficient if it did not look to the international experience, for it is outside the United States that these Funds were first established.

New Zealand was the trailblazer in 1929 with the world's first security

26 McKnight, *Clients' Security Fund*, 36 CAL. S.B.J. 963 (1961).

27 ABA JUNIOR BAR CONFERENCE REP., *supra* note 3 at 6.

28 Voorhees, *Clients' Security Fund in 1961: A Progress Report*, 47 A.B.A.J. 494, 495 (1961). The funds in operation have not experienced prohibitive costs. See note 88 *infra* and accompanying text.

29 See McKnight, *supra* note 26.

fund. Since then nineteen other funds have been created on foreign soil.³⁰ The New Zealand Fund is typical of many foreign funds. A compulsory annual contribution must be paid by every practicing solicitor before a practicing certificate will be issued for that year. In those years when the Fund exceeds £ 100,000, no contributions will be required.³¹ Solicitors must provide a monthly accounting of the funds held in trust for their clients. Moreover, audits must be conducted at least three times per year. In cases of suspected irregularities, the Law Society may demand production of a solicitor's private records and conduct its own audit.³² A claimant must first exhaust all legal remedies against the solicitor before applying to the Fund, and the Law Society encourages all solicitors to obtain appropriate insurance against thefts by their employees. In the event of such thefts, the Fund does not recognize the client's claim.³³ Similarly, no claim predicated upon negligence will be recognized. Commenting on thirty-six years' experience with the Fund, the Law Society Secretary was enthusiastic. "I think that it is universally accepted that the existence of the Fund has been most beneficial to the confidence which the public have reposed in the legal profession."³⁴

Unlike the policy of New Zealand and most other countries, including the United States, in Queensland, Australia, payment of a claim is *mandatory* provided the aggrieved client discharges his burden of proof.³⁵

Contributions are on a sliding scale in England. During the first three years of a solicitor's practice, he is required to pay nothing. From then until his sixth year, he must pay only one-half the regular assessment. At that point he begins to pay the entire annual contribution of £ 10. The advantages of such a sliding scale to the young lawyer are obvious. Audits of the accounts of solicitors who hold clients' funds are compulsory, and the Law Society may initiate

| | | | | |
|----|-------------------|------|-----------------------|------|
| 30 | Australia | | Ontario | 1957 |
| | New South Wales | 1935 | Quebec | 1956 |
| | Queensland | 1930 | Saskatchewan | 1949 |
| | Southern Tasmania | 1959 | Denmark | 1954 |
| | Victoria | 1948 | England | 1941 |
| | Canada | | Ireland | 1954 |
| | Alberta | 1939 | New Zealand | 1929 |
| | British Columbia | 1949 | Northern Ireland | 1963 |
| | Manitoba | 1943 | Scotland | 1949 |
| | New Brunswick | 1957 | Sweden | 1960 |
| | Nova Scotia | 1957 | Union of South Africa | 1941 |

This list is derived from the following sources: ABA JUNIOR BAR CONFERENCE REP., *supra* note 3; McLEOD, REPORT EXPLAINING THE SECURITY OF CLIENTS' MONEYS; I. E. FIDELITY, GUARANTEE OR COMPENSATION FUNDS (Int'l Bar Ass'n Edinburgh Conference 1962).

31 McLEOD, *op. cit. supra* note 30, at 10. To date this amount has never been attained as a result of the successful claims which have been paid by the Fund. Nonetheless, the upper limit on the Fund will probably be raised due to inflationary pressures. New Zealand Law Society reply to NOTRE DAME LAWYER QUESTIONNAIRE.

32 McLEOD, *op. cit. supra* note 30, at 10.

33 New Zealand Law Society reply to NOTRE DAME LAWYER QUESTIONNAIRE. In contrast with the New Zealand restriction of coverage to solicitors' defalcations only, the English Fund authorizes awards for losses due to the dishonesty of solicitors or their *employees*. This broad coverage is unique. THE LAW SOCIETY COMPENSATION FUND (1957) on file with American Bar Ass'n, 1155 East 60th Street, Chicago, Ill. 60637.

34 New Zealand Law Society reply to NOTRE DAME LAWYER QUESTIONNAIRE.

35 McLEOD, *op. cit. supra* note 30, at 7. Ireland and South Africa have similar provisions. *Id.* at 11, 14. From 1952 through 1962, the balance of the Queensland Fund has grown. This is attributable to the fact that none of the claimants during that period had exhausted their civil remedies. *Id.* at 7.

an inspection of solicitors' books. The English Fund has no maximum limit on the size of awards; awards from the Fund are discretionary with the Law Society.³⁶

Sweden's Fund is notable for its simplicity. Contributions are voluntary; audits of accounts are not mandatory; and payments of awards are discretionary.³⁷

In Canada, the indemnification programs that were instituted were later followed in the United States. Commencing with Alberta in 1939, 8 of the 10 provinces now have independent funds administered by their separate law societies, which are analogous to state bar associations. The Quebec fund of \$30,000 is financed by a yearly contribution of \$5.00 per lawyer, with the power in the Bar to decree an additional levy if needed. From 1956 to 1964, the Bar paid \$70,858 to 31 aggrieved clients. These payments resulted from defalcations by 14 of Quebec's 2,953 lawyers.³⁸ One significant difference between the Quebec Fund and American funds is the former's insistence that all lawyers deposit clients' monies in a trust account.³⁹ As previously indicated, this safeguard is common outside the United States.⁴⁰ An average of 10 claims are filed annually against the \$175,000 British Columbia Fund. During 1965-1966 almost \$10,000 was awarded to clients, a figure much higher than in previous years.⁴¹

The experience other countries have had with clients' security funds has not dulled the enthusiasm of their supporters. William McLeod of New Zealand, after compiling his very thorough survey for the International Bar Association, was "prepared to declare unequivocally that a Guarantee or Compensation Fund is not only desirable but essential in maintaining or improving our reputation in the eyes of the public."⁴²

V. Analysis of American Programs

A. Administration of Funds on National, State, or Local Level

While the United States generally lagged behind the other English speaking and common law countries in accepting clients' security funds, the concept has spread very rapidly since Vermont established the first American fund in 1959. By 1961 9 states had established Funds, with 10 additional states

36 *Id.* at 7-9.

37 *Id.* at 15-16.

38 Barreau de la Province de Quebec reply to NOTRE DAME LAWYER QUESTIONNAIRE. During that nine-year period the total cost per lawyer was \$26.27. From 1939 until 1965 all the Canadian funds awarded a total of \$1,884,245 for 849 claims against 127 lawyers. *Ibid.* The Appendix plainly shows awards made from the embryonic American funds are much smaller.

39 Barreau de la Province de Quebec reply to NOTRE DAME LAWYER QUESTIONNAIRE. Lawyers are also obliged to maintain an accounting system consisting of a minimum of prescribed ledgers which the Barreau de la Province de Quebec examines. *Ibid.* British Columbia and Saskatchewan follow the practice of random, spot audits of lawyers' books. Hyman, *Dishonesty Is Causing the Legal Profession to Search Its Soul*, Toronto Globe & Mail, Aug. 13, 1960 (Magazine), p. 7.

40 Victoria, Queensland, England, New Zealand, Scotland, and South Africa have such requirements. McLEOD, *op. cit. supra* note 30. The Law Society of Ireland is also considering adopting similar rules. Proposal on file with ABA, note 33 *supra*.

41 The Law Society of British Columbia reply to NOTRE DAME LAWYER QUESTIONNAIRE. Nonetheless, the Law Society is satisfied. "We feel that the program has been a success." *Ibid.*

42 McLEOD, *op. cit. supra* note 30, at 18.

creating theirs by 1964. Today there are 28 states and 18 local bar associations who maintain clients' security funds.⁴³

This widespread acceptance of the security fund concept makes it necessary to inquire as to the proper level on which the funds should be administered — national, state, or local. Most of the foreign funds are administered through a national law society. Such a scheme is probably the most efficient one for a country such as England with its high degree of centralized control over the legal profession. In South Africa, on the other hand, the profession is directed through a number of separate law societies constituting the Association of Law Societies of South Africa. This more closely resembles the American structure, yet the South African fund is administered at the national level.⁴⁴ This question may be moot in the United States since there has been no significant support for administering a fund at the national level through the American Bar Association. The advantage to such an approach is found in the large balance the fund could maintain and in uniformity of administration. As a practical matter, however, it appears that as yet there is no national commitment to the principle of a clients' security fund. The NOTRE DAME LAWYER QUESTIONNAIRE indicated that, of the 22 states without Funds, many had no interest at all in the concept of a security fund, thus a national fund does not appear imminent.

The Canadian approach has been the most popular in the United States. Funds developed on the state level are suited to the state's own needs and resources. In many states awards from the fund are closely coordinated with disciplinary action administered separately by each bar association. Thus where the bar is integrated at the state level, the administration of a fund is vastly simplified. Nonetheless, of the 28 states with funds, only 14 are integrated. The disadvantage of separate programs on the state level is that some may be poorly structured or inadequately financed.

Presently eighteen funds are administered by local bar associations.⁴⁵ The great value of this approach is that it allows a fund to be created where the state bar association fails to do so. Philadelphia and Chicago are examples of local funds which are quite effective and maintain a large balance. Philadelphia functions independently of the State Fund,⁴⁶ while Chicago is administered jointly with the Illinois Fund.⁴⁷ Outside of the very large cities, however, it is more difficult for a local association to finance and maintain an adequate balance. Where the local fund does not significantly supplement the state fund, but only duplicates the efforts of an already adequate state fund, the need for the local fund is minimized.⁴⁸

43 See Appendix.

44 McLEOD, *op. cit. supra* note 30, at 13-15.

45 See Appendix.

46 Philadelphia Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

47 Chicago Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE. The Chicago Bar Ass'n finances the fund through assessments of its members who are not members of the Illinois State Bar Ass'n. *Ibid.*

48 Now that the Ohio State Fund is extending its coverage to include all practicing members of that nonintegrated bar, the Akron fund will be discontinued. Cleveland is also giving this matter consideration. Akron and Cleveland Bar Ass'ns replies to NOTRE DAME LAWYER QUESTIONNAIRE.

B. Self-insurance

A lack of interest by the insurance companies has determined whether a clients' security fund should be based upon a commercial insurance policy. The Alaska State Bar Association and two local Pennsylvania Associations have obtained commercial insurance. Up to this time no claims have been paid.⁴⁹ Thus far, however, no feasible insurance policy has been presented to the other states by the insurance industry. Whether or not insurers will develop a reasonably priced, sufficiently comprehensive policy covering lawyers' defalcations is still unknown. Vermont started in 1959 with commercial insurance, but in 1961 claims of \$7,500 against one lawyer crippled the Fund. Because the insurance carrier could no longer offer reasonable rates, Vermont set up a self-insured Fund through a dues increase.⁵⁰ England had this same experience; after two substantial claims were paid, the premiums were prohibitive.⁵¹

In addition to this problem, coverage through an insurer injects an outside party into a matter which the bar conceives to be a debt of honor. It is questionable whether the public would be as impressed with reimbursement when it does not appear to come directly from the pockets of the lawyers themselves.

The various responses to the NOTRE DAME LAWYER QUESTIONNAIRE indicated that many states have authorized their fund committees to purchase "excess" or "catastrophe" insurance to cover claims in excess of what the fund can safely pay. There is merit in this from the bar associations' point of view, but no insurers have developed an adequate policy for this risk either.

C. Coverage

Malpractice or disputes over fees are not within the purview of a clients' security fund. While the states use differing language it is clear that all of the funds have the same purpose, to provide protection against lawyers' defalcations. None of the bar associations replying to the NOTRE DAME LAWYER QUESTIONNAIRE extend the protection of the fund to the dishonest acts of attorneys' employees.

Some funds are restricted to the actions of a lawyer in the attorney-client relationship.⁵² But the preferable approach is to include even those activities where the lawyer acts in a fiduciary capacity, in some way dependent on his status as a lawyer.⁵³ There is little reason for not having this broad coverage; the purpose and aims of a clients' security fund demand it.

Dean Griswold's original proposal suggested a fund to protect against the misdeeds of *members* of the particular bar association administering the fund.⁵⁴

49 For \$10,000 coverage for one attorney, the annual premium is \$4.75 per lawyer. \$100,000 is the maximum coverage. [Aug. 1966] ABA SPECIAL COMMITTEE ON CLIENTS' SECURITY FUND REP. 4-5.

50 No claims have been made against the Fund since that time. *Ibid.*

51 McLEOD, *op. cit. supra* note 30, at 8.

52 *E.g.*, New Hampshire, North Dakota, West Virginia. NOTRE DAME LAWYER QUESTIONNAIRE.

53 Maine, Massachusetts, Minnesota, Missouri, New Mexico, Ohio, Pennsylvania, and South Dakota. NOTRE DAME LAWYER QUESTIONNAIRE.

54 Griswold, *supra* note 10.

All states, except New Jersey, have been more ambitious, however.⁵⁵ Ohio originally restricted coverage to bar association members; as of January 1, 1967, its fund will include all Ohio lawyers.⁵⁶ As has been indicated, 14 of the 28 fund states are not integrated. Nevertheless, these 14 have had few problems in financing such broad coverage.⁵⁷ Every lawyer has a stake in the reputation of his profession and in the losses suffered by the public due to the transgressions of members of his profession. To cover lawyers not belonging to the bar association is only reasonable under these circumstances, otherwise a fund's effectiveness would be diluted.

Minnesota requires only that the lawyer's dishonesty be somehow related to the practice of law by a Minnesota lawyer in that state.⁵⁸ This allows the fund committee wide discretion in determining the relation of the defalcation to practice in Minnesota. Ohio appears to be more restrictive. The act must arise out of practice within the state or while acting as a fiduciary for a trust or estate having an Ohio situs.⁵⁹ The latter requirement creates a problem of coverage where, for example, an Ohio attorney embezzles money from a foreign trust. In this case the victimized client may go uncompensated. The simplest solution here is contained in New Mexico's requirement that the attorney be only a "resident practicing member of the State Bar."⁶⁰

D. Payment as a Matter of Grace

All the security funds in the United States grant restitution as a matter of grace, not legal right. Further, no person may have a vested right in the fund as a third party beneficiary.⁶¹ This is in contrast with those funds, typified by the Queensland fund, where restitution is mandatory if the burden of proof is met.⁶² This difference is not as significant as it first appears. If the bar association that adopts a fund is not engaged in mere "tokenism" but is sincerely committed to paying the debt of honor envisaged by the fund, restitution will be made in all worthy cases. Dedication to the principle of the fund is a sufficient guarantee that it will be justly administered. Moreover, leaving awards to the committee's discretion allows greater flexibility in making only those payments which will not imperil the fund's balance.

E. Conditions of Eligibility and Exclusions from Coverage

Fund committees are empowered to prescribe rules. Those prescribed are

55 Less than half of the New Jersey lawyers are members of the State Bar Association. The fund committee desired to include all of the state's lawyers, but it was felt that it was necessary for the program's success to restrict coverage to Bar Association members exclusively. Materials on file with ABA, note 33 *supra*.

56 Ohio State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

57 See Appendix. Interestingly, all claims filed to date against Indiana's Fund have been based upon the defalcations of nonmember lawyers. Indiana State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

58 Materials on file with ABA, note 33 *supra*.

59 Ohio State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

60 New Mexico State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

61 See Appendix for a list of these Funds.

62 See note 35 *supra* and accompanying text.

fairly uniform.⁶³ After the client has identified the offending attorney and described the alleged unprofessional acts, the committee may conduct an investigation into the merits of the claim. If the complaint is insufficient in some respect, a hearing may be held or additional information sought from the client. Fairness dictates that the accused attorney be notified of the claim and be given a chance to answer it.⁶⁴ The Illinois rules provide that all proceedings are to be as informal as possible so that laymen may present their claims without the necessity of legal representation. Where the claimant needs the assistance of a lawyer "it will be assumed that the attorney is eager to help achieve the basic purpose of the Fund, and has agreed to render such legal services without compensation."⁶⁵ The wisdom of this provision is in its simplified form of procedure and the manner in which it distributes the professional responsibility to members of the legal community.

Some states demand that the client exhaust his legal remedies before applying to the fund.⁶⁶ Louisiana goes one step further, requiring the claimant to exhaust all possible remedies against any source legally or morally responsible.⁶⁷ Indiana requires evidence of the client's efforts to exhaust his legal remedies, which then is to be weighed in determining the merit of his claim.⁶⁸ Leaving the sufficiency of the client's exhaustion to the committee's discretion is the best approach, since this flexibility allows for individual consideration of the special circumstances of each case. Nonetheless, exhaustion of remedies is desirable because it allows those legally responsible for a defalcation to fulfill their obligation before the bar is asked to atone for it.

The period of limitations within which a claim must be brought in Indiana is six months.⁶⁹ Illinois has a six-month limitations period also, but it can be waived by the committee for good cause.⁷⁰ In Minnesota "staleness" is the only limitation.⁷¹ Maryland does not mention a period of limitations; presumably staleness would also be a consideration in determining the merit of a claim in that state. Once again, flexibility is the most desirable approach.

Claims arising before the establishment of the fund will not be recognized in most states.⁷² West Virginia and Louisiana further provide that no claims shall be paid until a specified balance is attained by the fund.⁷³ This serves

63 *E.g.*, Maine, Maryland, Massachusetts and Ohio. NOTRE DAME LAWYER QUESTIONNAIRE.

64 Illinois State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

65 *Ibid.*

66 Arizona and North Dakota. NOTRE DAME LAWYER QUESTIONNAIRE.

67 Louisiana State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

68 Indiana State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE. Minnesota asks only that a reasonable effort be made to exhaust the client's remedies. Where it would serve no purpose, exhaustion is not required. Materials on file with ABA, note 33 *supra*.

69 Claims must be filed within six months of discovery of the loss or within six months of disbarment, suspension, resignation, death, or judgment of incompetency of the lawyer. Indiana State Bar Ass'n reply *supra* note 68.

70 Illinois State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

71 Materials on file with ABA, note 33 *supra*.

72 *E.g.*, Maine, Maryland, and Washington. NOTRE DAME LAWYER QUESTIONNAIRE.

73 NOTRE DAME LAWYER QUESTIONNAIRE.

to protect an infant fund against large assaults when payments would imperil it.⁷⁴

The NOTRE DAME LAWYER QUESTIONNAIRE revealed widespread exclusion of losses suffered by spouses, relatives, partners or associates of the dishonest lawyer.⁷⁵ Oregon also excludes the losses of the lawyer's employees.⁷⁶ These restrictions are reasonable, but a further exclusion is worthy of consideration. Is it necessary to the aims of a clients' security fund that losses suffered by a *lawyer* who has sought the services of another lawyer be reimbursed? Certainly no great public relations benefit is gained from reimbursing another lawyer. Whether the profession's debt of honor here is identical with that which it owes a layman is not clear. One further exclusion of wide acceptance is that which denies coverage where the dishonest act is already covered by insurance or bond.

In many states no restitution is made unless the offending attorney has died; been adjudged mentally incompetent; been disbarred; been suspended from practice; or has resigned from the bar.⁷⁷ The requirement that disciplinary action first be taken against a lawyer simplifies the collection of evidence proving a defalcation. Minnesota exemplifies another popular approach. The Committee has "complete discretion" to pay claims. Death, disbarment, suspension, resignation, and the pendency of disciplinary proceedings are only factors which the Committee must weigh in making its decision. Disappearance of the lawyer is also a factor to be considered.⁷⁸

F. *Protecting the Fund*

A very important safeguard in many funds is that which allows payment of an award to be deferred.

The Committee shall be authorized and empowered to admit or reject such claims in whole or in part to the extent that funds are available to it, and the Committee shall have complete discretion in determining the order and the manner of payment of claims.⁷⁹

This protects the fund from depletion of its resources as a result of a few extra large claims. Where the balance would be endangered, payment may be spread over a period of years, or partial payment may be made immediately. Until the size of the clients' security fund is such that it is secure, this safeguard is a necessity.

Another device to protect the fund is the imposition of maximum limits on the amount that may be awarded. West Virginia has a limit of \$5,000 per

⁷⁴ Another solution to this problem is to provide for deferred payments where the balance in the fund is insufficient to allow lump sum awards.

⁷⁵ *E.g.*, Maine, Minnesota, Ohio, Oregon, and West Virginia. NOTRE DAME LAWYER QUESTIONNAIRE.

⁷⁶ Oregon State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

⁷⁷ *E.g.*, Massachusetts, Maine, and New Mexico. NOTRE DAME LAWYER QUESTIONNAIRE.

⁷⁸ Materials on file with ABA, note 33 *supra*. Oregon also vests great discretion in the committee. After restricting awards to cases where the attorney has died, been disbarred, etc., a catchall phrase allows restitution in any case which is deemed an "appropriate case for consideration." Oregon State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

⁷⁹ *E.g.*, Ohio State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

client and \$10,000 for the offenses of any single attorney.⁸⁰ Arizona's limit is \$25,000 for any one claim and a \$50,000 maximum limit on awards from the fund in a single year.⁸¹ The maximum limits in Arizona are quite generous; they should suffice to allow full restitution in most situations. A percentage limitation has been adopted in Massachusetts. "At no time shall the fund be depleted so that its balance is less than 20 percent of the total amount paid into the fund, exclusive of accumulated income, over the preceding ten years."⁸² Finally, some states, such as Maryland, provide no maximum limit on the size of awards, leaving the amount of the payment to be decided on a case-by-case basis.⁸³

The guidelines laid down for the Minnesota Committee to consider in exercising its discretion are quite comprehensive.

The Committee may . . . consider:

- (a) The condition of the Fund.
- (b) The nature and size of the claim presented.
- (c) The promptness of the person's action upon discovery of the lawyer's dishonest act.⁸⁴
- (d) The comparative hardship the person has suffered by the loss.
- (e) The degree to which the claimant's own conduct may have contributed to or made more likely the lawyer's dishonest act.
- (f) Such other factors as to the Committee may seem just and proper.⁸⁵

This last consideration is broad enough to give full consideration to the equitable nature of a clients' security fund. A list of guidelines is more appropriate to the concept of a debt of honor than a series of well defined specifications which would restrict the committee's discretion. Presumably its members will be imbued with the spirit underlying the fund and can be trusted to implement its principles.

G. Clients' Security Fund Committee

The NOTRE DAME LAWYER QUESTIONNAIRE showed no significant disparity among the various funds regarding administrative structure. The committees range in size from five to seven. They are authorized to hold, manage, and distribute the funds and may prescribe rules and procedures for managing fund affairs. While some committees have been empowered to purchase insurance if reasonably priced, none have found such a policy.⁸⁶

H. Creation and Maintenance of a Fund

Louisiana has the only state fund supported by voluntary contributions

80 West Virginia State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

81 Arizona State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

82 Massachusetts State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

83 Maryland State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

84 This approach obviates the need for a definite limitations period within which a claim must be presented.

85 Materials on file with ABA, note 33 *supra*.

86 *E.g.*, Arizona State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE. See note 50 *supra* and accompanying text.

from members of the bar.⁸⁷ All other funds are supported through appropriations from bar associations or directly from membership dues. Where the bar association annually makes contributions from its treasury, there is always a possibility that ultimately these contributions will cause an increase in the association's dues. The costs of a direct membership assessment have been reasonable to date. The Illinois Fund is financed by a one dollar contribution, which is included in the annual dues of the Bar Association; Oregon Bar Association members may pay up to five dollars annually.⁸⁸

Indiana created its Fund by initially appropriating \$10,000 from the state bar association's treasury. This approach is desirable because the fund is large enough to become operational immediately. Later a dues increase was used to maintain the fund.⁸⁹

As a condition of practicing law in Maryland, all lawyers must pay the annual fund assessment. If a lawyer refuses he may be enjoined from practicing law.⁹⁰ Maryland has adopted the English "sliding scale," whereby a young attorney in the first five years of practice must contribute only five dollars while everyone else must pay fifteen dollars annually.⁹¹ The impact of the Maryland approach is significant when it is noted that the bar is not integrated. Unquestionably this method of financing the fund is the most effective in the United States.

The Appendix indicates the size of funds today. New Mexico has a provision that no appropriations shall be made at those times when its Fund exceeds \$10,000.⁹² Maintenance of a fund at this level or below puts it at a great disadvantage in the event of a series of substantial, compensated claims. The larger the balance, the better prepared the fund will be to meet any unfortunate eventuality.

Every state replying to the NOTRE DAME LAWYER QUESTIONNAIRE has wisely insisted that awards be conditioned upon the execution of a subrogation agreement between the client and the bar association. The advantages to this provision are obvious.

VI. Conclusion

The scarcity of claims filed against existing funds should not be misinterpreted.⁹³ It does not indicate the absence of a need for a clients' security fund; rather, it supports the basic premise of the bar that the vast majority of its members are upstanding and qualified. It is the exception who gives the profession a "black-eye." It must also be kept in mind that these funds are very recent

87 Louisiana State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE. This may be changing since the Bar Association voted to appropriate \$1,000 to the Fund in 1966. [Aug. 1966] ABA SPECIAL COMMITTEE ON CLIENTS' SECURITY FUND REP. 3.

88 Illinois and Oregon. NOTRE DAME LAWYER QUESTIONNAIRE. The Alberta Fund costs each lawyer \$50 per annum, significantly greater than American assessments. Alberta Law Society reply to NOTRE DAME LAWYER QUESTIONNAIRE.

89 Indiana Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

90 This is similar to the New Zealand requirement that the annual contribution be paid before a practicing certificate will be issued. Note 31 *supra* and accompanying text.

91 Maryland State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

92 New Mexico State Bar Ass'n reply to NOTRE DAME LAWYER QUESTIONNAIRE.

93 See Appendix.

in origin and they have not been subjected to a true test of endurance. No doubt, as the public becomes more aware of their availability, American funds will be used with greater frequency. This development is not an event the profession must approach with trepidation because prudent management and planning should guarantee the financial security of the funds. The public, however, will only become more aware of the bar's decision to accept its debt of honor if sufficient publicity is given to the bar's activities in this area; this is crucial. All the good intentions and efforts of the profession will be for naught if it fails to notify the layman that it stands willing to reimburse the losses suffered by victims of unscrupulous lawyers.

To insure maximum protection to the public, the bar should discuss and debate the desirability and feasibility of conducting periodic audits of lawyers' accounts such as is done in England. This suggestion might ultimately prove impractical in the face of the costs incurred through the administration of an auditing system. In addition, the small number of annual defalcations might not warrant such an expense, but it deserves consideration.

In conclusion it can safely be said that the clients' security fund concept has met with growing acceptance since its birth in 1929. Experience has demonstrated the financial stability of these funds. Experience has also clearly shown a clients' security fund can significantly affect the public image of the profession. Finally, the fact that the bar has embraced the spirit of compensating aggrieved clients evidences its preeminent dedication to the public good.

John Thomas Hartly

APPENDIX

| <i>State Bar Funds</i> | <i>Established</i> | <i>Balance</i> | <i>Claims Paid To Date</i> |
|--|---------------------|----------------------|----------------------------|
| *Alaska | 1962 | Commercially insured | None |
| *Arizona | 1961 | \$43,000 | \$5,850 |
| Colorado | 1960 | 24,312 | 5,687 |
| Connecticut | 1960 | 36,000 | 294 |
| *Florida | 1966 | 25,000 | None |
| **Illinois | 1962 | 75,000 | 5,417 |
| Indiana | 1961 | 20,000 | 500 |
| *Louisiana | 1961 | 16,128 | None |
| Maine | 1963 | 10,328 | None |
| Maryland | 1966 | Undetermined | None |
| Massachusetts | 1964 | 20,000 | None |
| *Michigan | 1966 | 10,000 | None |
| Minnesota | 1964 | 78,381 | None |
| *Missouri | 1966 | 10,000 | None |
| New Hampshire | 1961 | 18,891 | None |
| New Jersey | 1962 | 52,500 | None |
| *New Mexico | 1960 | 7,000 | None |
| New York | 1963 | 42,544 | None |
| *North Dakota | 1962 | 10,500 | None |
| Ohio | 1961 | 79,322 | 24,465 |
| *Oklahoma | 1965 | 10,000 | None |
| *Oregon | 1966 | Undetermined | None |
| Pennsylvania | 1960 | 70,000 | 1,500 |
| *South Dakota | 1964 | 1,500 | None |
| Vermont | 1959 | 11,518 | None since self-insured |
| *Washington | 1960 | 68,642 | 4,548 |
| *West Virginia | 1964 | 10,000 | None |
| *Wyoming | 1966 | 7,500 | None |
| <i>Local Bar Funds</i> | | | |
| Los Angeles County, Cal. | 1963 | 20,882 | None |
| Baltimore, Md. | 1961 | 37,385 | 5,236 |
| Montgomery County, Md. | 1963 | 3,000 | None |
| Akron, Ohio | 1962 | 5,000 | 350 |
| Cleveland, Ohio | 1962 | 24,413 | 500 |
| N.Y. County Lawyers Ass'n, N.Y. | 1963 | 39,050 | 365 |
| Philadelphia and ten other Pennsylvania Counties | 1960 <i>et seq.</i> | 127,587 | 26,000 |
| Suffolk County, N.Y. | 1966 | 7,500 | None |

* Integrated bar.

** Joint with Chicago Bar Ass'n.

The figures in this Appendix were derived from [Aug. 1966] ABA SPECIAL COMMITTEE ON CLIENTS' SECURITY FUNDS REP. 11, and were supplemented with material from the NOTRE DAME LAWYER QUESTIONNAIRE. Further information may be secured from Mr. Karl Williams, Chairman of ABA Special Committee on Clients' Security Funds, 230 News Tower, Rockford, Ill. 61104 or Committee Services, American Bar Ass'n, 1155 East 60th Street, Chicago, Ill. 60637.

SUBDIVISION EXACTIONS: WHERE IS THE LIMIT?

I. Introduction

When raw acreage is subdivided into residential lots, it is inconvenient to convey these small parcels by metes and bounds descriptions. As a result, American law has long recognized that subdivided land can be validly conveyed by reference to lot numbers on recorded subdivision maps.

Deeds making reference to plats were upheld in cases dating back to the early part of the eighteenth century;¹ this method of transfer has never been seriously questioned. The early plat deeds, however, were unofficial and completely free of government regulation. As a result, they were highly inaccurate. Since it was relatively simple for dishonest promoters to sell lots by reference to fraudulently inaccurate maps, several states passed statutes requiring recorded maps to be drawn to scale and compelling the inclusion of essential details.² Even under these statutes, however, it was possible for privately prepared and recorded maps to disagree with the "assessor's plats" used by public officials in assessing property taxes.³ Thus, later statutes provided that maps could not be recorded without the approval of a designated municipal taxing official, who could disapprove any map that did not conform to the "assessor's plat."⁴ The guardian of this regulatory system was the keeper of public records, whose duty was to see that no map was filed without official approval.⁵

When subdivision maps were disapproved for lack of surveying accuracy, the courts found little difficulty in upholding the refusal: "There was no right to record, they said, only a privilege, and if the landowner did not wish to avail himself of this privilege he could still convey by metes and bounds."⁶ Of course, this analysis begged the entire question, and in so doing, failed to set adequate standards for judicial review of the approval process. More incisive courts recognized that the process was valid not because recording was a "privilege," but because the municipality had a right to assure the accuracy of its tax rolls.⁷ The actual abuses resulting from the "right-privilege" theory were minimal, for the surveying-accuracy statutes presented little opportunity for administrative discretion or arbitrariness. The problem is that the "right-privilege" theory has been carried over into the judicial analysis of modern subdivision controls, where it has obscured important constitutional questions.⁸

1 *Williams v. First Presbyterian Soc'y*, 1 Ohio St. 478 (1853), upholding a plat deed executed in 1789; *Middlebury College v. Cheney*, 1 Vt. 336 (1828), sustaining a plat deed of 1813.

2 HORACK & NOLAN, *LAND USE CONTROLS* 202 (1955).

3 See BEUSCHER, *LAND USE CONTROLS* 227 (3d ed. 1964).

4 For a discussion of such a statute see *Trawalter v. Schaefer*, 142 Tex. 521, 179 S.W.2d 765 (1944).

5 BEUSCHER, *op. cit. supra* note 3, at 217-18; HORACK & NOLAN, *op. cit. supra* note 2, at 202.

6 HORACK & NOLAN, *op. cit. supra* note 2, at 203.

7 *Trawalter v. Schaefer*, 142 Tex. 521, 179 S.W.2d 765 (1944).

8 *E.g.*, *Newton v. American Security Co.* 201 Ark. 943, 148 S.W.2d 311 (1941); *Ayers v. City Council*, 34 Cal. 2d 31, 207 P.2d 1 (1949); *Petterson v. City of Naperville*, 9 Ill. 2d 233, 137 N.E.2d 371 (1956); *Billings Properties, Inc. v. Yellowstone County*, 144 Mont. 25, 394 P.2d 182 (1964).

This right-privilege analysis has led some municipalities to impose conditions on the

Subdivision controls were limited largely to assuring the accuracy and simplicity of subdivision maps until the Great Real Estate Boom and Crash of the 1920's. Following the Crash, strict controls were enacted in response to the abuses of "fly-by-night" promoters.⁹ Typically, these promoters would arrange with local landowners to subdivide and sell their land in exchange for a share of the proceeds. The promoter would then sell the most desirable lots for a quick profit and leave town. Since the unfortunate owner was left holding land assessable as residential lots instead of raw acreage, the city inevitably was forced to acquire his "white elephant subdivision" at a tax sale.¹⁰ As a result of these activities, the countryside surrounding the city was permanently marred by partially developed, poorly planned subdivisions.

Taxpayers also lost in other ways. The purchasers who actually built on the land soon petitioned the city for water, sewers, streets, parks, and other public improvements. Of course, the costs of such improvements were specially assessed to the benefited properties, but the holders of vacant lots soon found the tax burden unbearable as a result. Thus, parcel after parcel of the remaining land would fall into the hands of the local government, and "the taxpayers in already developed areas were forced to pay for public improvements of no use to them and of very little use to anyone else."¹¹

It was in response to these abuses that modern subdivision controls were first enacted on a grand scale. These statutes had two basic purposes: 1) To insure that subdivisions would be built in conformity with the community plan. 2) To compel subdivider-developers to carry the financial burden of providing public improvements for the subdivision.¹² The statutory methods of enforcement were similar to those used by earlier platting statutes. Generally, a state enabling act was passed making it a criminal offense to sell lots by reference to unrecorded maps, and making it unlawful for the keeper of public records to record subdivision maps which had not been approved by the local planning commission. The commission was then given authority to pass regulations requiring sub-

"privilege" of acquiring building permits. This requirement has been justly attacked:

In defending the practice of requiring dedication by abutting properties for widening an existing street, advocates of the practice often declare that the principle involved is no different from the principle of requiring full dedication of streets in a new subdivision. But there is actually a material difference. In the case of the initial dedication of streets by a new subdivision, the entire street pattern is first determined and the land devoted to street purposes is subtracted from the *total* area of the subdivision. After the street pattern has been determined, the lot sizes, shapes, and arrangements are worked out. Consequently, the resulting lots are completely usable because their design has been adapted to the prior pattern of streets which are to serve them. In the case of dedications for the widening of an existing street, only the individual abutting lots carry the burden, and they carry it unequally. Whitnall, *Conditions Attached to Platting and Zoning*, 5 INSTITUTE ON PLANNING AND ZONING 129, 164 (1964). Such building permit conditions would be struck down under either the "specifically and uniquely attributable test" (See note 20 *infra*) or the special assessment analysis (See notes 29-37 *infra*).

9 BETTMAN, CITY AND REGIONAL PLANNING PAPERS 74 (1946); see also II LEWIS, PLANNING THE MODERN CITY 151-53 (1949).

10 11 LEWIS, *op. cit. supra* note 9, at 151-53, reprinted in HORACK & NOLAN, *op. cit. supra* note 2, at 204.

11 *Ibid.*

12 Reps & Smith, *Control of Urban Land Subdivision*, 14 SYRACUSE L. REV. 405, 408 (1963).

dividers to conform to the community master plan, dedicate land for public sites, and make public improvements as conditions precedent to plat approval.¹³

It would clearly be a valid exercise of the police power to require developers to "reserve" public sites within their subdivisions to minimize the cost of future condemnation by the city.¹⁴ Similar to zoning ordinances and official maps, such a requirement would consist of negative prohibitions, and would be sufficient to give the community effective control over the layout and design of proposed subdivisions.¹⁵ However, modern subdivision controls seek not only to control the *design* of subdivisions, but also to *shift the burden of subdivision improvement* from the general public to the individual subdivider through a system of positive exactions. These positive subdivision exactions — forced dedication of land, required construction of capital improvements, and compulsory payment of equalization fees — go far beyond the normal exercises of the police power, and are subject to grave constitutional doubts.

II. Forced Dedication of Land

In many localities, when a subdivider approaches the local planning commission to request its approval of his subdivision plan, he may be asked to dedicate a portion of his subdivision for streets, parks, playgrounds, and other public sites. If he refuses, his plan will not be approved.¹⁶

This practice of requiring land dedication as a condition precedent to plat approval looks suspiciously like a cloaked and unconstitutional exercise of the power of eminent domain. Although the great majority of courts have held that just compensation is not required,¹⁷ they have not been particularly adept in explaining why. The dominant judicial attitude toward forced dedication was forged in two celebrated cases — *Ayres v. City Council*¹⁸ and *Pioneer Trust & Sav. Bank v. Village of Mount Prospect*.¹⁹ This theory is apparently that the

¹³ BEUSCHER, *op. cit. supra* note 3, at 218.

¹⁴ *E.g.*, *Town of Windsor v. Whitney*, 95 Conn. 357, 111 Atl. 354 (1920); *Headley v. City of Rochester*, 272 N.Y. 197, 5 N.E.2d 198 (1936); *Halsell v. Ferguson*, 109 Tex. 144, 202 S.W. 317 (1918). Such regulations are enforced by refusing building permits in "reserved" areas, with exceptions allowed in hardship cases. See BEUSCHER, *op. cit. supra* note 3, at 205-06. See also Kucirek & Beuscher, *Wisconsin's Official Map Law*, 1957 Wis. L. Rev. 176.

¹⁵ Even unofficial master plans, with no sanctions attached, can influence the conduct of subdividers. It would be a very foolish businessman who would construct a house on a lot designated for future public condemnation, and a foolish purchaser who would buy such a house if it were built. It is simply impractical to design subdivisions not in conformity with the master plan. See generally, Cram, *Master Planning Creates Clouds on Titles*, Mich. S.B.J., April 1956, p. 9.

¹⁶ For comprehensive discussions of subdivision control legislation see Note, *An Analysis of Subdivision Control Legislation*, 28 IND. L.J. 544 (1953); Note, *Platting, Planning & Protection—A Summary of Subdivision Statutes*, 36 N.Y.U.L. REV. 1205 (1961).

¹⁷ *E.g.*, *Newton v. American Security Co.*, 201 Ark. 943, 148 S.W.2d 311 (1941); *Ayres v. City Council*, 34 Cal. 2d 31, 207 P.2d 1 (1949); *Ridgefield Land Co. v. City of Detroit*, 241 Mich. 468, 217 N.W. 58 (1928); *Billings Properties, Inc. v. Yellowstone County*, 144 Mont. 25, 394 P.2d 182 (1964); *Lake Secor Dev. Co. v. Ruge*, 141 Misc. 913, 252 N.Y.S. 809 (1931), *aff'd*, 235 App. Div. 678, 255 N.Y.S. 853 (1932); *Jordan v. Village of Menomonee Falls*, 28 Wis. 2d 608, 137 N.W.2d 442 (1965).

¹⁸ 34 Cal. 2d 31, 207 P.2d 1 (1949).

¹⁹ 22 Ill. 2d 375, 176 N.E.2d 799 (1961).

police power is not limited to prohibiting land uses which are harmful to the public, but is broad enough to require a subdivider "to assume those costs which are specifically and uniquely attributable to his activity and which would otherwise be cast upon the public."²⁰

This is certainly a new doctrine. Traditionally, the police power authorizes the state to prohibit only uses of property which are *harmful* to the public; it does not authorize the confiscation of property simply because it is *useful* to the public.²¹ Indeed, as Justice Holmes has succinctly noted, "the protection of private property in the Fifth Amendment presupposes that it is wanted for public use, but provides that it shall not be taken for such use without compensation."²² None of the cases to date have squarely faced the question of why an uncompensated taking for public use is unconstitutional in all areas but that of subdivision controls. Rather than confront this issue, the courts have attempted to conjure up a distinction by alluding to the old and discredited "right-privilege" theory:

The error in plaintiff's position is the assumption that in requiring an additional dedication and the establishment of a building line to conform to its general plan, the city is exercising power of eminent domain. Its argument would have merit and the authorities cited would have application if this were a case where the plat had been recorded and the city were undertaking to widen the streets or to establish a building line. But this is not such a case. Here the city is not trying to compel a dedication. It cannot compel the plaintiff to subdivide its property or to dedicate any part of it for streets. It can, however, impose any reasonable condition which must be complied with before the subdivision is accepted for record. In theory, at least, the owner of a subdivision voluntarily dedicates sufficient land for

20 *Id.* at 379, 176 N.E.2d at 801. This test has been variously applied by the courts. In *Pioneer Trust & Sav. Bank v. Village of Mount Prospect*, *supra* note 19, the Illinois Supreme Court applied the rule with so much rigor as to leave in doubt the possibility of requiring school land dedication in Illinois. The court held that if existing school facilities are near capacity, the subdivider cannot be required to dedicate land for schools because the need for additional classrooms arises from the total development of the community and not the subdivider's activities. In *Jordan v. Village of Menomonee Falls*, 28 Wis. 2d 608, 137 N.W.2d 442 (1965), the Wisconsin Supreme Court implied that the rule had been too restrictively applied by the Illinois court, and held that only a reasonable connection between the needed improvements and the subdivider's activity had to be shown. The Montana Supreme Court relaxed the rule even further in *Billings Properties, Inc. v. Yellowstone County*, 144 Mont. 25, 394 P.2d 182 (1964), by holding that legislative requirements would not be upset unless there could be no rational basis for finding that the required improvements were specifically and uniquely attributable to the subdivision development.

21 The distinction between "taking" and "regulation" is well-stated by Nichols in his classic work on eminent domain:

The distinguishing characteristic between eminent domain and the police power is that the former involves the *taking* of property because of its need for the public use while the latter involves the *regulation* of such property to prevent the use thereof in a manner that is detrimental to the public interest. 1 NICHOLS, EMINENT DOMAIN 87 (1964). Nichols also makes this observation:

[I]t is universally conceded that when land or other property is actually taken from the owner and put to use by the public authorities, the constitutional obligation to make just compensation arises, however much the use to which the property is put may enhance the public health, morals or safety. *Id.* at 90-91.

See generally Kucera, *Eminent Domain Versus Police Power—A Common Misconception*, 1959 INSTITUTE ON EMINENT DOMAIN 1.

22 *Pennsylvania Coal Co. v. Mahon*, 260 U.S. 393, 415 (1922).

streets in return for the advantage and privilege of having his plat recorded. Unless he does so, the law gives him no right to have it recorded.²³

It would be meaningless to discuss whether recordation is a "right" or a "privilege," for this is only convenient labeling which does not approach the heart of the issues involved. Recordation is merely the statutory point of control at which the municipality has been authorized to assert its authority; it is not a source of power in itself, but merely a method of enforcement. Most courts have impliedly recognized that local governments have no power to condition recordation, unless 1) authority to do so has been granted by the legislature, and 2) this legislative grant is within the powers conferred by the constitution.²⁴ Unfortunately, however, these courts have completely ignored the eminent domain question and upheld the legislative grant as within the police power, without explaining the origin of the police power's extra potency in this regard.

The difficulty that courts have experienced in explaining subdivision exactions, under the police power, tends to indicate that such exactions are not exercises of the police power at all. The essence of these requirements appears to be taxation — not regulation. In no real sense do they regulate subdivisions in the interest of the "public health, safety, or welfare"; rather, they are efforts by the community to shift the financial burden of providing necessary public improvements in new subdivisions. This is a tax problem, and it ought to be treated accordingly.

The first determination concerning these subdivision exactions is where the real incidence of the "tax" falls — to whom does the public shift its burden? Commentators on the problem have assumed that forced dedications and other exactions shift the capital costs for new improvements from the old residents in already developed areas to the newcomers²⁵ who will inhabit the proposed subdivisions.²⁶ This assumption is completely untrue. The subdivider sells his lots at whatever price the market will bear, not at a fixed percentage above cost.

23 *Ridgefield Land Co. v. City of Detroit*, 241 Mich. 468, 472, 217 N.W. 58, 59 (1928). For more recent cases partially relying on the *Ridgefield* approach see *Ayers v. City Council*, 34 Cal. 2d 31, 207 P.2d 1 (1949); *Petterson v. City of Naperville*, 9 Ill. 2d 233, 137 N.E.2d 371 (1956); *Billings Properties, Inc. v. Yellowstone County*, 144 Mont. 25, 394 P.2d 182 (1964). Typically, these cases justify subdivision exactions under the police power, and then use the "right-privilege" theory to explain why just compensation is not required for what seems to be an obvious taking.

24 *E.g.*, *Kelber v. City of Upland*, 155 Cal. App. 2d 631, 318 P.2d 561 (1957); *Pioneer Trust & Sav. Bank v. Village of Mount Prospect*, 22 Ill. 2d 375, 176 N.E.2d 799 (1961); *Pennyton Homes, Inc. v. Planning Bd. of Stanhope*, 41 N.J. 578, 197 A.2d 870 (1964); *Jordan v. Village of Menomonee Falls*, 28 Wis. 2d 608, 137 N.W.2d 442 (1965).

25 When speaking of suburban communities on the urban fringe, it is probably valid to assume that new subdivisions will be inhabited by incoming city dwellers. In other communities, this "newcomer" assumption is probably unwarranted.

26 *E.g.*, *Heyman & Gilhool, The Constitutionality of Imposing Increased Community Costs on New Suburban Residents Through Subdivision Exactions*, 73 YALE L.J. 1119, 1121 (1964); *Whitnall, supra* note 8, at 129.

The failure to understand that the real incidence of the tax falls upon the subdivider has led to unwarranted attacks on subdivision exactions:

The questionable phase of the practice was the fact that the portion of the city already subdivided had made no contributions either in land or money to the acquisition of recreational areas. Therefore, it appeared an obvious discrimination to require new subdivisions to contribute the whole cost. Even the most ardent advocate of recreational facilities must acknowledge the soundness of this reasoning.

Whitnall, supra note 8, at 129.

Thus, if the municipality pays for all subdivision improvements, the subdivider will be the only one to benefit. Such improvements make the subdivision more desirable, and the market price increases accordingly. In effect, public installation of improvements merely increases the subdivider's profits at public expense, without benefiting the ultimate purchaser. Subdivision exactions are aimed at eliminating the subdivider's undeserved windfall by making him pay for the improvements he will later sell as part of his "stock in trade." Theoretically, the cost of lots to the ultimate purchaser will remain the same in either event — whether improvements are financed publicly or privately.²⁷ Prices will be increased only if the subdivider is forced to assume the burden of financing improvements which do not proportionately increase the market value of the remaining subdivision land.

If subdivision exactions are to be analyzed as taxes, it appears that they can best be characterized as special assessments for improvements which uniquely benefit subdivided land. Most state constitutions require that taxes be uniformly imposed throughout the relevant jurisdiction.²⁸ Special assessments, however, are imposed upon land which will benefit from improvements in a way and to a degree not enjoyed by the community as a whole.²⁹ For this reason, special assessments need not be uniform throughout the jurisdiction, but only uniform within the benefited district.³⁰ The crucial limitation on special assessments is that the improvement being financed must create a "local" advantage:

Whether or not an improvement is local or general depends upon the nature of the improvement and whether the substantial benefits to be derived are local or general in their nature. If its purpose and effect are to improve a locality, it is a local improvement, although there is incidental benefit to the public, but, if the primary purpose and effect are to benefit the public, it is not a local improvement although it may incidentally benefit property in a particular locality.³¹

Even if it is determined that a special assessment can validly be imposed, the amount of the assessment cannot be unreasonable. Thus, if the assessment substantially exceeds the amount of benefit received by the assessed property, it will be invalid.³² The amount of benefit is normally proved by expert testimony as to the increase, if any, in market values:

The inquiry is how much has the particular public improvement added to the fair market value of the property, as between a willing seller and a willing buyer, with reference to all the uses to which it is reasonably adapted

²⁷ For example, imagine two subdivisions identical in every way, except that one's improvements had been financed by city funds and the other's had been paid for by the subdivider. Since both are equally desirable, both would command the same price on the market.

²⁸ INDEX DIGEST OF STATE CONSTITUTIONS 993-95 (1959).

²⁹ 2 ANTIEAU, MUNICIPAL CORPORATIONS 291 (1965).

³⁰ 14 McQUILLIN, MUNICIPAL CORPORATIONS 43 (1950); RHYNE, MUNICIPAL LAW 724 (1957).

³¹ Village of Downers Grove v. Bailey, 325 Ill. 186, 190-91; 156 N.E. 362, 363 (1927).

³² 2 ANTIEAU, *op. cit. supra* note 29, at § 14.11.

and for which it is plainly available, prospective as well as present, by strangers as well as by the owner?³³

It appears that the rules developed by the courts for determining the validity of special assessments could be readily applied to subdivision exactions. Reps and Smith have suggested that subdivision exactions should be presumptively limited to those improvements traditionally financed by special assessment — that is, streets, sewers, sidewalks, neighborhood parks, and the like. Under this theory, dedication of land for schools, fire stations, and city-wide parks would be suspect, because these improvements have traditionally been financed with public funds.³⁴ While the Reps and Smith presumption has been attacked,³⁵ it appears to have the merit of lending a degree of certainty to an unstable area of the law. Whatever its merits, however, this presumption should not be irrebuttable. Subdivision exactions are *sui generis* and cannot be strictly governed by special assessment precedents, most of which deal with assessments in already developed areas. Subdivisions approaching the size of new towns are not entirely uncommon,³⁶ and it is clear that such subdivisions are specially and locally benefited by all public facilities constructed to serve the needs of the future inhabitants. In such cases it may be appropriate for the municipality to require the subdivider to dedicate land and construct buildings for schools, fire stations, water purification plants and other community-wide facilities. In smaller subdivisions, it would probably be invalid to require the subdivider to bear all the capital costs of installing community-wide facilities, but it would be within the special assessing power to require him to pay his proportionate share of the improvements,³⁷ or perhaps dedicate the land necessary for their installation.

The key to decision in these cases must be the amount of windfall that would otherwise accrue to the subdivider. The public can require him to pay — in the form of land, improvements, or money — the amount by which the market value of his lots will increase as a result of the improvements. This amount can be determined with reasonable accuracy by expert real estate appraisers.

III. Required Construction of Capital Improvements

In addition to forcing land dedications, many jurisdictions require subdividers to install paved streets, drainage ditches, curbs, sidewalks, water mains, street lighting, and other public improvements, all in accordance with the standards and specifications of the appropriate municipal department. Much that has been said with regard to forced dedications is equally applicable here. As

33 *Driscoll v. Northbridge*, 210 Mass. 151, 155, 96 N.E. 59, 61 (1911).

34 Reps & Smith, *supra* note 12, at 409-10. (1963). It should be noted that Reps and Smith do not characterize subdivision exactions as special assessments. Rather, they say that when the police power is used to make such positive exactions, it should be limited by analogy to special assessments.

35 Heyman & Gilhood, *supra* note 26, at 1146-49.

36 *Lake Secor Dev. Co. v. Ruge*, 141 Misc. 913, 252 N.Y.S. 809 (1931), *aff'd*, 235 App. Div. 678, 255 N.Y.S. 853 (1932), involved a 2,000-lot subdivision.

37 It is in these smaller subdivisions that equalization fees are of great service, for such fees allow the city great latitude in making the tax burden proportionate to the improvement benefit.

with forced dedication provisions, the courts have upheld installation requirements as valid exercises of the police power,³⁸ as long as the improvements are deemed to be "specifically and uniquely attributable" to the subdivider's activities.³⁹ Again, however, it appears that the real basis for these decisions is not the police power, but the power of the municipality to specially assess property owners for "local" improvements.⁴⁰ The improvement of subdivisions with paved streets, gutters, and sidewalks makes the property more attractive on the market. To the extent that the market value of the property is increased by these improvements, the municipality can require the subdivider to pay the costs. As with other special assessments, the exactions are valid unless the subdivider can show through expert testimony that the required cost of installation is substantially in excess of the amount of special benefit received.

Under the Reps and Smith presumption,⁴¹ installation requirements limited to traditionally local improvements would probably be valid. Also, in special circumstances,⁴² subdividers could probably be required to construct school buildings, fire stations, and other public structures. In the normal case, however, it would be invalid to require the subdivider to assume the entire burden of constructing these community-wide improvements. As in all other instances, his pro rata share must be approximately limited to the amount by which the improvement will increase the fair market value of his lots.⁴³

IV. Equalization Fees

Land dedicated or improvements made within a subdivision will presumably increase the market value of the rest of the tract; the very location of the improvements tends to insure a special benefit to the subdivider. When community-wide improvements are involved, however, these conventional subdivision exactions are often impractical. The subdivision's pro rata share in the benefit from a community-wide improvement may be so small that it would be unlawful to

38 Sidewalks, curbs and gutters: *Evola v. Wendt Constr. Co.*, 170 Cal. App. 2d 21, 338 P.2d 498 (1959); *Petterson v. City of Naperville*, 9 Ill. 2d 233, 137 N.E.2d 371 (1956); *Allen v. Stockwell*, 210 Mich. 488, 178 N.W. 27 (1920).

Drainage Facilities: *City of Buena Park v. Boyar*, 186 Cal. App. 2d 61, 8 Cal. Rptr. 674 (1960); *Blevens v. Manchester*, 103 N.H. 284, 170 A.2d 121 (1961).

Sewage and Water Facilities: *Longridge Estates v. City of Los Angeles*, 183 Cal. App. 2d 533, 6 Cal. Rptr. 900 (1960); *Mefford v. City of Tulare*, 102 Cal. App. 2d 919, 228 P.2d 847 (1951); *Blevens v. Manchester*, 103 N.H. 284, 170 A.2d 121 (1961); *Lake Intervale Homes, Inc. v. Township of Parsippany-Troy Hills*, 28 N.J. 423, 147 A.2d 28 (1958); *Zastrow v. Village of Brown Deer*, 9 Wis. 2d 100, 100 N.W.2d 359 (1960).

Street Widening and Extensions: *Ayers v. City Council*, 34 Cal. 2d 31, 207 P.2d 1 (1949); *Crescent Dev. Corp. v. Planning Comm'n*, 148 Conn. 145, 168 A.2d 547 (1961); *Petterson v. City of Naperville*, 9 Ill. 2d 233, 137 N.E.2d 371 (1956); *Rettig v. Planning Bd. of Rowley*, 332 Mass. 476, 126 N.E.2d 104 (1955); *Brous v. Smith*, 304 N.Y. 164, 106 N.E.2d 503 (1952).

39 The leading cases are *Ayers v. City Council*, 34 Cal. 2d 31, 207 P.2d 1 (1949), and *Pioneer Trust & Sav. Bank v. Village of Mount Prospect*, 22 Ill. 2d 375, 176 N.E.2d 799 (1961).

40 See notes 29-37 *supra*.

41 See note 36 *supra*.

42 Essential to a showing of "special circumstances" would be expert testimony that the subdivider's lots would increase in value by an amount approximately equal to the cost of constructing such community-wide facilities.

43 See note 32 *supra*.

require the subdivider to construct the entire improvement, and impractical to require him to build a part of it. Likewise, the amount of land required for dedications of public sites may vary from postage-stamp sized tracts to several acres, depending on the size of the subdivision. Thus, forced land dedication often leads to "a hodgepodge of municipal holdings many of which are too small or wrongly situated for the purpose for which they were intended to serve."⁴⁴

These practical difficulties have led some municipalities to enact an alternative provision allowing the local planning commission to impose equalization fees in lieu of land and improvement requirements.⁴⁵ The funds thus received are then used by the city to acquire capital improvements in accordance with the community master plan.⁴⁶

A majority of decisions have held these fees invalid, apparently on the ground that they were beyond the scope of the state enabling act.⁴⁷ At the same time, these courts criticized the fact that the funds generated by such fees were not reserved for the special benefit of the subdivision but could be spent for the benefit of the community at large.⁴⁸ In view of these adverse comments, it is not unreasonable to suggest that specific, fee-authorizing statutes in these states might be held unconstitutional unless the resultant funds are required to be spent for improvements in the vicinity of the assessed subdivision.

The basis for these adverse comments appears to be the feeling that equalization fees are valid exercises of the police power as long as they are limited to the benefit of the assessed subdivision, but are unconstitutional taxes if they can be spent for the community as a whole.⁴⁹ However, such fees are probably taxes in either case. Professor Cooley says that a demand for money can be upheld under the police power only if its primary purpose is regulation. If its primary purpose is revenue, it is an exercise of the taxing power and must be treated as such.⁵⁰ Equalization fees are primarily a revenue-raising device, and this is true

44 Cutler, *Legal and Illegal Methods of Controlling Growth on the Urban Fringe*, 1961 Wis. L. Rev. 370, 391.

45 Many suburban communities have experienced rapid growth over the last two decades, and now have very little undeveloped land within their jurisdiction. It is in these communities that "postage-stamp" holdings are likely to become a serious problem.

46 Whitnall, *supra* note 8, at 139.

47 *Kelber v. City of Upland*, 155 Cal. App. 2d 631, 318 P.2d 561 (1957); *Rosen v. Village of Downers Grove*, 19 Ill. 2d 448, 167 N.E.2d 230 (1960); *Coronado Dev. Co. v. City of McPherson*, 189 Kan. 174, 368 P.2d 51 (1962); *Haugen v. Gleason*, 226 Or. 99, 359 P.2d 108 (1961).

48 *Kelber v. City of Upland*, 155 Cal. App. 2d 631, 318 P.2d 561, 566 (1957); *Rosen v. Village of Downers Grove*, 19 Ill. 2d 448, 453, 167 N.E.2d 230, 234 (1960); *Coronado Dev. Co. v. City of McPherson*, 189 Kan. 174, 368 P.2d 51, 53 (1962); *Haugen v. Gleason*, 226 Or. 99, 359 P.2d 108, 111 (1961). In addition, see *Lake Intervale Homes, Inc. v. Township of Parsippany-Troy Hills*, 28 N.J. 423, 147 A.2d 28 (1958) where a subdivider was refunded his share of the cost of installing water mains in a subdivision because he was forced to bear the costs without regard to the benefits being conferred by the improvement.

There is also a line of authority upholding equalization fees which were required to be spent for the direct benefit of the subdivision taxed: *City of Buena Park v. Boyar*, 186 Cal. App. 2d 61, 8 Cal. Rptr. 674 (1960); *County Council v. Lee*, 219 Md. 209, 148 A.2d 568 (1959); *Town of Stoneham v. Savelo*, 341 Mass. 456, 170 N.E.2d 417 (1960).

49 The Oregon court's attitude is well summarized in this sentence: "The decision to seek money with which to buy other land which might benefit another subdivision, or the public generally, took the county into the borderline area between the police power and the power to tax." *Haugen v. Gleason*, 226 Or. 99, 359 P.2d 108, 110 (1961).

50 4 COOLEY, TAXATION § 1784 (1924).

whether they are spent inside or outside the subdivision. The crucial fact is that they are *taxes in the nature of a special assessment*, and are invalid unless they produce direct benefits to the assessed property.

Equalization fees have been upheld by courts in Wisconsin, *Jordan v. Village of Menomonee Falls*,⁵¹ and New York, *Jenad, Inc. v. Village of Scarsdale*,⁵² even though the resultant funds could be spent anywhere in the community. In *Jenad*, a badly divided New York Court of Appeals abruptly dismissed the subdivider's contention that unlimited equalization fees amounted to an unconstitutional tax: "We think that this labeling distorts the purpose and meaning of the requirements. This is not a tax at all but a reasonable form of village planning for the general community good."⁵³ The majority opinion then launched a feeble attempt to defend its own "labeling" by stating that subdivision fees are "merely a kind of zoning," and also akin to other police power regulations. Conveniently missing was any reference to the traditional distinction between negative prohibitions and positive exactions.⁵⁴ The majority then equated equalization fees with other subdivision exactions, but begged the question on whether these also might be taxes: "One arrangement is no more a 'tax' or 'illegal taking' than the other."⁵⁵

In *Jordan*, the Wisconsin Supreme Court was more frank and less cavalier. The majority admitted that equalization fees were taxes and not police power regulations. It argued, however, that the fees were not special assessments, but were more in the nature of an excise tax on the privilege of obtaining approval of the plat. Since excise taxes, like special assessments, are not subject to the normal constitutional requirement of uniformity in taxation, the court felt that the fees were valid even though they could be used for the needs of the entire community.⁵⁶

The classification of subdivision exactions as "excise taxes" ignores both the history and the purpose of these measures. Such exactions originated not as taxes upon the privilege of recordation, but as an attempt to make dishonest promoters pay their fair share of local subdivision improvements.⁵⁷ The purpose of such exactions has never been the raising of general revenue; rather, as E. C. Yokley has noted, the purpose was to gain reimbursement for special benefits conferred: "Since the subdivider of land creates the need for local improvements which are of special benefit to the subdivision, it is considered reasonable that he should bear the cost rather than the municipality and the general taxpayer."⁵⁸

51 28 Wis. 2d 608, 137 N.W.2d 442 (1965).

52 18 N.Y.2d 78, 218 N.E.2d 673 (1966).

53 218 N.E.2d at 1676.

54 *Ibid.*

55 *Ibid.*

56 28 Wis. 2d 608, 137 N.D.2d 442, 450 (1965). Doebele, in his proposed enabling act for the State of New Mexico, also characterized subdivision exactions as "excise taxes." However, it is interesting to note that his proposed statute required the resulting funds to be earmarked for the acquisition of improvements "in a place within or sufficiently close to said subdivision to be of direct benefit to it and its inhabitants." Doebele, *Improved State Enabling Legislation for the Nineteen-Sixties: New Proposals for the State of New Mexico*, 2 NATURAL RESOURCES J. 321, 341 (1962).

57 See notes 9-11 *supra*.

58 2 YORLEY, ZONING LAW & PRACTICE 46 (3d ed. 1965).

This is the rhetoric of special assessments, not excise taxes. To call such fees "excise taxes" is to conjure up a fiction to reach the wrong result.

The taxes imposed in *Jenad* and *Jordan* were discriminatory and unfair. The fees were used for general purposes, such as schools and off-site parks, which are traditionally financed from general public funds. Such assessments can only be justified when the location of the general improvement insures some tangible special benefit to the subdivision which has been singled out for the special tax; there was no such assurance in either case. In effect, subdivision exactions in these states are no longer limited to depriving subdividers of undeserved profits. Instead, they will increase his costs without increasing the market value of his lots. In such a case, one of two things will happen, with the purchaser the loser in either event. If market conditions are such that the tax burden can readily be shifted to the purchaser, he will be forced to pay a higher price for his lot without receiving resultant benefits. If, on the other hand, the subdivider is forced to absorb the tax burden, he will have less incentive to engage in new subdivision activities. As the supply of lots decreases, newcomers will be forced to either pay a higher price for available lots or seek an older house in developed parts of the city. Thus, whenever additional tax burdens are imposed on subdividers without conferring proportionate benefits, the ultimate purchasers will be injured.

The danger of such discrimination against outsiders is far from academic. Fast-growing suburban communities are constantly seeking methods of excluding incoming city dwellers or of preventing their migration except at a price.⁵⁹ The *Jenad-Jordan* result gives these communities a perfect tool for such exclusion and extortion. Thus it appears that the better reasoned approach was voiced by Justice Van Voorhis in his dissent from the *Jenad* decision:

[T]here must be apportionment of the [tax] burdens, either among all the property-owners of the State, or of the local division of the State, or the property-owners specially benefitted by the improvements. In either case, if one is required to pay more than his share, he receives no corresponding benefit for the excess, and that may properly be styled extortion or confiscation. A tax or assessment upon property arbitrarily imposed, without reference to some system of just apportionment, could not be upheld.⁶⁰

V. Conclusion

Subdivision exactions have been consistently justified as exercises of the police power. The cases have held such "regulations" reasonable so long as they do no more than impose upon the subdivider the costs which are "specifically and uniquely attributable" to his activities. This position is in conflict with traditional views on both the police and taxing powers. Thus, it appears that subdivision exactions are in fact taxes in the nature of special assessments requiring the subdivider to bear the cost of local improvements which are made necessary by his activities and are productive of special benefits to his subdivision.

⁵⁹ See generally, Cutler, *supra* note 44.

⁶⁰ *Jenad, Inc. v. Village of Scarsdale*, 18 N.Y.2d 78, 218 N.E.2d 673, 677 (1966) (dissenting opinion).

Such special subdivision assessments do not shift the burden of public improvements from taxpayers in already developed areas to the residents of newly developed subdivisions. Rather, the subdivider bears the incidence of the tax. Subdivision improvements increase the market value of the subdivided land. This increase will be reflected in lot prices even if the public paid for the improvements. Thus, subdivision exactions merely prevent subdividers from making unfair monetary gains at the expense of the public.

A pair of recent cases have held that funds resulting from subdivision exactions need not be expended for the special benefit of the subdivision, but may be spent anywhere in the community. In effect, these holdings force newcomers to assume additional burdens without receiving additional benefits. This is discriminatory taxation in one of its less attractive forms. Wiser courts have allowed the established community to impose special taxes on newcomers only if special benefits are also conferred.⁶¹ Hopefully, this attitude marks the trend for the future.

J. Gregory Walta

61 See notes 47-50 *supra* and accompanying text.

THE LEGAL STATUS OF FRANCHISES THAT SPECIFY THAT A DEALER MUST CONFINE HIS SALES TO A DESIGNATED TERRITORY.

“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 hereby declared to be illegal.”*

I. Introduction

The franchise system is one of the greatest business devices of the present day.¹ Under this device a manufacturer or the holder of a patent or trademark grants the privilege of marketing his product to another. This results in the expenditure of large sums of money by the franchised dealer to start his business. Because of this investment, the dealer naturally desires certain guarantees that the venture will be financially rewarding. The best guarantee is to be designated an exclusive dealer of the product in a designated area. This designation insures against competition by other holders of the same franchise. Of course, the manufacturer also wants his interest protected since his business success depends upon the quality of his dealers. He therefore wants to attract good dealers, who can reach a wide segment of the purchasing public. If some of these dealers fail, not only are other good men discouraged from purchasing the manufacturer's franchise, but also the reputation of his product is damaged. Therefore, the manufacturer is careful not to franchise more dealers than the public can profitably support. Geographic considerations weigh heavily in this determination.

II. Closed Territories

No one would controvert the fact that a manufacturer can employ agents to distribute his product to the public and also assign specified territories to them. However, whether a manufacturer can assign an exclusive franchise² and simultaneously impose a territorial restriction upon the franchised dealer is open to debate at the present time.

* Sherman Act § 1, 26 Stat. 209 (1890), as amended, 15 U.S.C. § 1 (1964).

1 *Fortunes in Franchising*, DUNS REV., April, 1964, p. 36.

2 The exclusive franchise, in which the manufacturer refuses to deal with all but one dealer in a given area, absent any territorial restrictions, is legal subject to the rule of reason. See *Ace Beer Distribs., Inc. v. Kohn, Inc.*, 318 F.2d 283 (6th Cir.), *cert. denied*, 375 U.S. 922 (1963); *Packard Motor Car Co. v. Webster Motor Car Co.*, 243 F.2d 418 (D.C. Cir.), *cert. denied*, 355 U.S. 822 (1957); *Reliable Volkswagen Sales & Serv. Co. v. World-Wide Auto. Corp.*, 182 F. Supp. 412 (D.N.J. 1960); *Schwing Motor Co. v. Hudson Sales Corp.*, 138 F. Supp. 899 (D. Md. 1956), *aff'd*, 239 F.2d 176 (4th Cir.), *cert. denied*, 355 U.S. 823 (1957). The district court in the last case declared:

Every manufacturer has a natural and complete monopoly of his particular product, especially when sold under his own private brand or trade name If he is engaged in a private business, he is free to exploit this monopoly by selling his product directly to the ultimate consumer or through one or more distributors or dealers, as he may deem most profitable to him. If he chooses the latter method, he may exercise his own independent discretion as to the parties with whom he will deal. This is a common law right which the anti-trust laws have not destroyed. . . . A refusal to deal becomes illegal only when it produces an unreasonable restraint of trade or a monopoly forbidden by the anti-trust laws.

A manufacturer may prefer to deal with one person rather than another, and

Vertical territorial restrictions, or allocations, may take a variety of forms. A dealer may be prohibited from moving his place of business without the consent of the manufacturer, or a restriction may prevent the dealer from soliciting customers outside his geographic area. A more stringent provision may provide that if the dealer is approached by customers outside his territory, he must refer them to the dealer in their area. The franchise contract might also contain various enforcement provisions ranging from the payment of a nominal "penalty" to a dealer whose territory has been invaded to the loss of an offending dealer's franchise.

There are many reasons why it would be to a manufacturer's advantage to include these restrictions in a franchise agreement.³ In most cases, they will prevent the franchised dealers from dissipating their energies on intrabrand competition rather than interbrand competition. Since a product should reach as many customers as possible, a manufacturer will want to spread his dealers over a wide area to achieve greater distribution of his product. The tendency among dealers, however, is to attract the most willing customers in a wide geographical area and to neglect those who need more persuasion. Thus, it may be in the interest of the manufacturer to restrict a dealer's area and thereby force him to concentrate on attracting the hard-to-get customer. Also, the effect of allowing several dealers in the same brand to compete vigorously in its sale may be to destroy respect that consumers have for the quality of the product. Likewise, vigorous intrabrand competition might destroy the price that the dealer can command for his product.

A further situation in which the manufacturer might desire to impose a territorial restriction clause upon his franchised dealer is where goods requiring servicing are being sold. It is of the greatest importance to the integrity of the manufacturer's product that consumers know that if they purchase that product it will be adequately serviced. A customer will prefer to purchase a product from an established, reputable dealer where he can always be assured of excellent servicing should the product so require, rather than from some transient salesman who is unavailable when something goes wrong. Moreover, recent developments in the area of products liability place greater burdens upon the manufacturer. Territorial restrictions may aid the manufacturer to identify and trace defective goods, while also enabling him to warn purchasers of the defect. Finally, exclusive franchises may be necessary for the manufacturer to attract quality dealers. Where a product is new and the dealer has to engage in exten-

may grant exclusive contracts in a particular territory. . . . Unless his contract so provides, a dealer once appointed has no tenure, no right to a renewal of his contract. . . . Such limited monopolies are not invalid . . . unless they are used to violate the anti-trust laws. They may not be used to extend the producers' monopoly into other fields Nor may they be used to establish market dominance and drive out the products of competitors. *Id.* at 902-03.

See also Day, *Exclusive Territorial Arrangements Under the Antitrust Laws—A Reappraisal*, 40 N.C.L. REV. 223 (1962); Stewart, *Antitrust Considerations Involved in Product Distribution*, 19 BUS. LAW 967 (1964).

³ See, e.g., Stone, *Closed Territorial Distribution: An Opening Question in the Sherman Act* 30 U. CHI. L. REV. 286 (1963); Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795, 809 (1962); Note, *Exclusive Territorial Arrangements and the Antitrust Laws*, 39 IND. L.J. 785 (1964).

sive promotional activities, or has to expend a large amount of capital to start his business, a dealer will hesitate to begin the venture unless he has some sort of guarantee that his potential customers will not be lured from him. Territorial restrictions in the franchises granted by the manufacturer will adequately serve this purpose. Thus, the interests of manufacturers and dealers are quite clear.

The interest of the consuming public is also quite clear; the best possible product is desired at the lowest possible price. These various restrictions will probably have a price-fixing effect in most cases, especially where there is a lack of vigorous interbrand competition. Since the dealer has his own sales area, secure from other dealers in the same product, he can set his own price without fear of being undersold.⁴ Franchise restrictions also have a monopolizing effect from the consumer's point of view. The reputation of a dealer may be as great an influence in the sale of a product as the reputation of the product itself. Thus, territorial allocations, especially the type forbidding a dealer to sell to customers outside of his territory, may force a consumer either to deal with a dealer he does not like or trust or else defer his purchase of this particular product.

III. The Department of Justice v. The Judiciary

The Justice Department is quite consistent in its contention that these vertical territorial allocations are illegal per se.⁵ It analogizes them to horizontal territorial restrictions — illegal per se⁶ — where the competing dealers themselves combine to divide up possible customers. The Department notes that the ultimate effect upon commerce is the same whether the dealers themselves effect the division of customers or whether their customers are divided for them by the manufacturer. The Justice Department's attitude has resulted from its dealings with the automobile industry. That industry had used exclusive franchises and imposed penalties on those who sold outside of their territories. These penalties

⁴ See Stone, *supra* note 3.

[T]he very *raison d'être* of a distributor's wanting closed territories, over and above the protection of exclusives, is the expectation of immunity from competition even when prices in his area rise so high as to attract his neighbors to bear the costs of invasion—when, from the public's point of view, cross-selling would be most welcome. The increased prices which closed territories would thus seem to effect are not even apt to be offset by competitively desirable increases in output. This is true even though one of the most important reasons for a manufacturer's acceding to closed territories is the expectation of receiving services by virtue of which *his* product's output will increase; for in holding out closed territories as an inducement for distributors to handle his brand, a manufacturer is, in effect, attracting their efforts away, if not from the disposal of a more competitively distributed brand of the same product, from some other sector of the economy. In fact, the very reasons for which the promise of closed territories facilitates the entries of some firms may make them retard entry, tying up the allegiances of available outlets so as to bar still other potential entrants unless they, too, are prepared to respond with closed territories. *Id.* at 315.

⁵ See, e.g., Averill, *Antitrust Considerations of the Principle Distribution Restrictions in Franchise Agreements*, 15 AM. U.L. REV. 28, 51 (1965); Timberg, *Territorial Exclusives*, 21 BUS. LAW 59 (1965).

⁶ See, e.g., *Timkin Roller Bearing Co. v. United States*, 341 U.S. 593 (1951); *United States v. Addyston Pipe & Steel Co.*, 175 U.S. 211 (1899), *affirming* 85 Fed. 271 (6th Cir. 1898); and *Gray Line Inc. v. Gray Line Sightseeing Co.*, 246 F. Supp. 495 (N.D. Cal. 1965), where the court said, "Evidence of justification, necessity, good faith, or beneficial results is immaterial and will not be heard." *Id.* at 499.

ranged from thirty-five dollars for Chevrolet dealers to 150 dollars for Cadillac dealers.⁷ In 1950 the Justice Department warned the automobile companies that it considered these restraints illegal; the industry struck them from their franchise agreements. Several unsuccessful attempts were later made to secure legal approval of these arrangements in Congress.⁸ Emboldened by this success, the Department has since gone on to attack similar provisions in other industries. There has been a general reluctance on the part of manufacturers to contest the Department's position; most parties have simply entered consent decrees agreeing to abandon the practice.⁹ This timidity has caused a void in the case law on the legal status of vertical territorial restrictions in franchise agreements.

Early cases refused to find anything illegal in territorial clauses, but they offer little guidance to a manufacturer seeking to avoid Justice Department scrutiny. In *Phillips v. Iola Portland Cement Co.*,¹⁰ a contract for cement stated that the buyers would not sell outside the state of Texas. The Eighth Circuit noted:

The Iola Cement Company had no monopoly of the manufacture or sale of cement in the United States. It was surrounded by competing manufacturers, and the contract which it made with Parr & Co., of Galveston, had no direct or substantial effect upon competition in trade among the states. It left the manufacturers who were competing with the plaintiff for the trade of the country free to select their customers, to fix their prices, and

7 See statement of Senator Hruska, *Hearings on S. 997, S. 2042, S. 2047, S. 2151 Before a Subcommittee of the Senate Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 7 (1959).

8 *Hearings on H.R. 10201 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 86th Cong., 2d Sess. (1960); *Hearings on S. 997, S. 2042, S. 2047, S. 2151 Before a Subcommittee of the Senate Committee on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. (1959); *Hearings on S. 3865 Before the Senate Committee on Interstate and Foreign Commerce*, 85th Cong., 2d Sess. (1958); *Hearings on H.R. 528, H.R. 2688, H.R. 6544 Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 84th Cong., 1st Sess. (1956).

9 *U.S. v. United Merchants & Mfrs.*, 5 Trade Reg. Rep. ¶ 71864 (S.D.N.Y. 1966); *U.S. v. Pyrotronics, Inc.*, 5 Trade Reg. Rep. ¶ 71858 (D.N.J. 1966); *U.S. v. Studebaker Corp.*, 1965 Trade Cas. ¶ 71410 (D. Neb. 1965); *U.S. v. Elgin Corp.*, 1965 Trade Cas. ¶ 71339 (N.D. Ill. 1965); *U.S. v. York Corp.*, 1963 Trade Cas. ¶ 70946 (M.D. Pa. 1963); *U.S. v. Greater N.Y. Roll Bakers Ass'n*, 1963 Trade Cas. ¶ 70788 (S.D. N.Y. 1963); *U.S. v. Sperry Rand Corp.*, 1962 Trade Cas. ¶ 70495 (W.D.N.Y. 1962); *U.S. v. Arnold, Schwinn & Co.*, 1962 Trade Cas. ¶ 70445 (N.D. Ill. 1962); *U.S. v. Spring Air Co.*, 1962 Trade Cas. ¶ 70402 (N.D. Ill. 1962); *U.S. v. Audiofidelity, Inc.*, 1960 Trade Cas. ¶ 69760 (S.D.N.Y. 1960); *U.S. v. Restonic Corp.*, 1960 Trade Cas. ¶ 69739 (N.D. Ill. 1960); *U.S. v. Hambro Automatic Corp.*, 1960 Trade Cas. ¶ 69620 (S.D.N.Y. 1960); *U.S. v. Bostitch, Inc.*, 1958 Trade Cas. ¶ 69207 (D.R.I. 1958); *U.S. v. American Type Founders Co.*, 1958 Trade Cas. ¶ 69065 (D.N.J. 1958); *U.S. v. American Body & Trailer, Inc.*, 1958 Trade Cas. ¶ 69063 (W.D. Okla. 1958); *U.S. v. Rudolph Wurlitzer Co.*, 1958 Trade Cas. ¶ 69011 (W.D.N.Y. 1958); *U.S. v. Necchi Sewing Mach. Sales Corp.*, 1958 Trade Cas. ¶ 68957 (S.D.N.Y. 1958); *U.S. v. AMI, Inc.*, 1957 Trade Cas. ¶ 68758 (W.D. Mich. 1957); *U.S. v. Seeburg Corp.*, 1957 Trade Cas. ¶ 68613 (N.D. Ill. 1957); *U.S. v. American Linen Supply Co.*, 1956 Trade Cas. ¶ 68542 (N.D. Ill. 1956); *U.S. v. National Wrestling Alliance*, 1956 Trade Cas. ¶ 68507 (S.D. Iowa); *U.S. v. Philco Corp.*, 1956 Trade Cas. ¶ 68409 (E.D. Pa. 1956); *U.S. v. Western Elec. Co.*, 1956 Trade Cas. ¶ 68246 (D.N.J. 1956); *U.S. v. Reddi-Whip Inc.*, 1955 Trade Cas. ¶ 68187 (S.D. Cal. 1955); *U.S. v. Liberty Nat'l Life Ins. Co.*, 1954 Trade Cas. ¶ 67801 (N.D. Ala. 1954); *U.S. v. Austenal Labs., Inc.*, 1950-51 Trade Cas. ¶ 62880 (S.D.N.Y. 1951); *U.S. v. American Optical Co.*, 1950-51 Trade Cas. ¶ 62869 (N.D. Ill. 1951); *U.S. v. Bendix Home Appliances, Inc.*, 1948-49 Trade Cas. ¶ 62346 (S.D.N.Y. 1948); *U.S. v. Libby-Owens-Ford Glass Co.*, 1948-49 Trade Cas. ¶ 62323 (N.D. Ohio 1948); *U.S. v. Dick Co.*, 1948-49 Trade Cas. ¶ 62233 (N.D. Ohio 1948).

10 125 Fed. 593 (8th Cir.), *cert. denied*, 192 U.S. 606 (1903). This case was cited and followed in *Cole Motor Car Co. v. Hurst*, 228 Fed. 280 (5th Cir. 1915), *cert. denied*, 247 U.S. 511 (1917).

to dictate their terms for the sales of the commodities they offered, so that in this regard no restraint whatever was imposed. If it had the effect to restrain Parr & Co. from using the product which they purchased to compete with other jobbers or manufacturers in the country beyond the limits of the state of Texas, this restriction was not the chief purpose or the main effect of the contract of sale, but a mere indirect and immaterial incident of it. The agreement of sale imposed no direct restriction upon competition in commerce among the states, did not constitute a restraint of that commerce, and was not obnoxious to the provisions of the Act of July 2, 1890.¹¹

A few years later, Ford Motor Co. brought suit against various parties who were representing themselves as Ford agents while selling below the Ford retail price.¹² The defendants contended that Ford's agency contracts appointed an agent to sell and service Ford cars in a defined territory for a stipulated price and thus violated the antitrust laws. The dealer paid 85% of the list retail price, the full consideration, but Ford retained title to the car until a bill of sale signed by it was delivered to the retail purchaser. The court refused to recognize defendants' claim of illegality as a defense and noted that Ford had no monopoly in the automotive industry: "[T]he public already has competition to the fullest extent desirable."¹³ It also saw no way in which the public would be benefited "by requiring the manufacturer to assume the further burden of internal guerrilla competition with the confusion and waste entailed thereby."¹⁴

Similarly, though *Boro Hall Corp. v. General Motors Corp.*¹⁵ involved no actual restriction on the sale of cars, the Second Circuit upheld General Motors' refusal to allow one of its dealers to establish a used car lot outside of its "zone of influence" — a limited area in the downtown section of Brooklyn — without the consent of a G.M. regional manager. The court stated:

We think the effect of the proof is that General Motors Sales Corporation required no more than that the location of a used car depot should be fixed by agreement at such a place as would not unduly prejudice other dealers who did business with the seller. We do not regard this as an unreasonable interference with competition or an unfair arrangement between the plaintiff and General Motors Sales Corporation.¹⁶

In another case, thirty-four small bedding manufacturers formed an association, Spring Air Co., to enable them to compete with major producers. The agreement contained a division of trade territories. The association secured trademarks, provided uniform specifications for its bedding products, and engaged in national advertising. One of the manufacturers attempted to withdraw from the association; Spring Air brought suit and recovered the defendant's share of advertising expenses owed under the Association's contract.¹⁷ The defendant contended that the contract violated the antitrust laws. The Court

11 *Phillips v. Iola Portland Cement Co.*, *supra* note 10, at 595.

12 *Ford Motor Co. v. Benjamin E. Boone, Inc.*, 244 Fed. 335 (9th Cir. 1917).

13 *Id.* at 341.

14 *Ibid.*

15 124 F.2d 822 (2d Cir. 1942), *cert. denied*, 317 U.S. 695 (1943).

16 *Id.* at 823.

17 *Denison Mattress Factory v. Spring-Air Co.*, 308 F.2d 403 (5th Cir. 1962).

noted that it must look to the primary purpose of the contract. If the purpose is a legitimate business objective, rather than to just increase market control, incidental restraints will not be unlawful.¹⁸ It found that the agreement went no further than to protect Spring Air trademarks.¹⁹

With the courts continually upholding the legality of vertical territorial restrictions and the Justice Department holding that they are illegal per se, it was inevitable that the Supreme Court would be called upon to express its views on this subject. It did so in *White Motor Co. v. United States*.²⁰ White manufactures and sells trucks to distributors, dealers, and various customers. Both the distributors and dealers sold trucks to these same customers. White restricted the territories within which its dealers or distributors could sell. The Justice Department contended that these restrictions were unlawful per se under the Sherman Act. The district court entered summary judgment for the government and White appealed. White contended that its restrictions were legal because there was extensive competition in the truck manufacturing industry; it could not afford to sell directly to the public; and it wanted to promote competition with other truck manufacturers and not among its own salesmen.²¹ The Justice Department asked the Court to extend its decisions on horizontal restrictions to vertical restrictions.²² Unfortunately, the Court simply remanded the case to the district court, noting:

This is the first case involving a territorial restriction in a *vertical* arrangement; and we know too little of the actual impact of both that restriction and the one respecting customers to reach a conclusion on the bare bones of the documentary evidence before us.²³

Justice Brennan concurred, stating:

Territorial limitations bear at least a superficial resemblance to horizontal divisions of markets among competitors, which we have held to be tantamount to agreements not to compete, and hence inevitably violative of the Sherman Act. . . . If it were clear that the territorial restrictions involved in this case had been induced solely or even primarily by appellant's dealers and distributors, it would make no difference to their legality that the restrictions were formally imposed by the manufacturer rather than through inter-dealer agreement. . . . But for aught that the present record discloses, an equally plausible inference is that the territorial restraints were imposed upon unwilling distributors by the manufacturer to serve exclusively his own interests.²⁴

18 *Id.* at 408.

19 *Id.* at 409. The Court stated:

In our opinion, Spring-Air not only had a right to license its trademark to exclusive dealers, but also had an affirmative duty to itself and to the public to invoke some kind of control and restraint upon its various licensees to prevent losing its property rights thereunder. It is our opinion that the provision of the contract with respect to a division of trade territory in the circumstances of this case is not offensive to the antitrust laws. The division of territory was not the central purpose of the contract. *Ibid.*

20 372 U.S. 253 (1963).

21 *Id.* at 256-57.

22 *Id.* at 261.

23 *Ibid.*

24 *Id.* at 267.

Justice Clark, dissenting, said that the restrictions should be illegal and noted that "the existence of interbrand competition has never been a justification for an explicit agreement to eliminate competition."²⁵

It would seem that the Supreme Court's language in *White* encourages manufacturers, whose restrictions have been attacked by the Justice Department, to bring their cases to court in the hope of validating them, but there has been a general reluctance to do so.²⁶ Even White Motor Company, upon the remand of its case, entered a consent decree agreeing to abandon its restrictions rather than contest the Justice Department's position.²⁷

In 1964, the Justice Department brought suit against the Sealy Corporation because of its provisions for exclusive marketing territories.²⁸ The Department again argued that these provisions were illegal per se. Sealy said they served legitimate business purposes. Sealy holds the Sealy trademark and engages in national advertising. It allocated territories among its thirty licensees, who then did the actual manufacturing. After disputes among the licensees over territories, territories were fixed in 1926 on the basis of freight rates. Each manufacturer was restricted to a specific territory within which he could manufacture and sell Sealy products. The court concluded that the assignment of territories was not an unreasonable restraint of trade but was a proper protection of the Sealy trademark.²⁹

In *United States v. Schwinn & Co.*, however, a district court found a territorial allocation clause to be illegal.³⁰ In that case the government charged that Schwinn, Schwinn Cycle Distributors Association, and various dealers conspired to allocate territories. Schwinn was charged with enforcing the conspiracy. Schwinn instituted its franchise system shortly after the war to combat a declining market and to enable it to compete with the larger manufacturers. The Schwinn distribution system consisted basically of two methods. Under the first, distributors actually took orders on a commission basis and the goods were then shipped out by Schwinn. The court found that under this arrangement the distributor was clearly an agent and that Schwinn had a right to allocate territories to its agents.³¹ Under the second method, where the distributor took title to the bicycle and assumed all risks, the court viewed his position differently. To avoid the duplication of effort caused by distributors selling to the same retailers, Schwinn attempted to put one distributor in each area. Under this plan, territories were unilaterally allocated to the distributors with the knowledge and consent of the Schwinn Cycle Distributors Association. In most cases Schwinn merely assigned each dealer primary responsibility for his area. Among some distributors, however, more restricted practices were employed. Certain distributors could sell only to customers within their territory and if approached by outsiders they would have to refer them to the distributor assigned to their

25 *Id.* at 278.

26 See note 9 *supra*.

27 1964 Trade Cas. ¶ 71195 (N.D. Ohio 1964).

28 *United States v. Sealy*, 1964 Trade Cas. ¶ 71258 (N.D. Ill. 1964).

29 *Ibid.*

30 *United States v. Schwinn & Co.*, 237 F. Supp. 323 (N.D. Ill. 1965), *prob. juris. noted*, 382 U.S. 936 (1966).

31 *Id.* at 342.

area. The court held that Schwinn could continue to allocate specific territories for prime responsibility, but it found the agreements to confine the sales of some distributors to certain territories an unreasonable restraint of trade and illegal per se under section 1 of the Sherman Act.³² The Supreme Court has noted probable jurisdiction in this case,³³ and perhaps more light will be shed on the subject should the Court undertake to analyze the territorial restrictions involved.³⁴

IV. The FTC v. The Judiciary

The Federal Trade Commission has varied in its views toward vertical territorial restrictions. Originally it refused to find anything illegal in confining a distributor to an exclusive territory,³⁵ but it has retreated from this position. In *Snap-On Tools Corp. v. FTC*,³⁶ the Seventh Circuit was forced to review a determination by the FTC that certain territorial restrictions were illegal. The hearing examiner had dismissed a complaint, saying such clauses were legal. The Commission found the clauses unlawful because they were part of a formal scheme of distribution and contributed to the overall illegality of that scheme.³⁷ Under the scheme, route dealers had specified territories within which they were assigned to sell tools. They demonstrated, serviced, repaired, and sold tools; advised customers as to their use; and collected time payment accounts and rent payments on large equipment rentals. The court refused to find these clauses illegal. Rather than looking at the collective effect of all the restraints employed by Snap-On, the court considered each clause by itself. It noted that there were over eighty competing manufacturers and that interbrand competition was actually promoted rather than restricted by Snap-On's practices.³⁸ The court stated:

[T]here are certain advantages to a manufacturer . . . in requiring an exclusive territorial arrangement with its dealers which promotes (rather than suppresses) in a broad, meaningful way, competition between it and other manufacturers or similar products, and which therefore justify a minimal curtailment of intrabrand competition among its dealers. . . . In the absence of the maintenance of a very large corp of salesmen, employees, the practice of exclusive territories for its dealers appears to be the only way in which respondent can be assured that sales territories will be adequately worked, that periodic calls will be made on customers, and that satisfactory service will be rendered customers.³⁹

32 *Ibid.*

33 *United States v. Schwinn & Co.*, 382 U.S. 936 (1966).

34 The Supreme Court recently avoided the question of whether a clause prohibiting a dealer from moving to a different location without the consent of the manufacturer was illegal. *United States v. General Motors Corp.*, 384 U.S. 127 (1966). The court refused consideration on the clause as it was not referred to in the complaint and was only injected into the trial by way of defense. *Id.* at 139.

35 *Sealy, Inc.*, 45 F.T.C. 730 (1948); *General Cigar Co.*, 16 F.T.C. 537 (1932).

36 321 F.2d 825 (7th Cir. 1963).

37 *Snap-On Tools Corp.*, 59 F.T.C. 1035 (1961).

38 *Snap-On Tools Corp.*, *supra* note 36 at 833.

39 *Id.* at 831-32.

In *Sandura v. FTC*,⁴⁰ the Sixth Circuit reversed a finding of the FTC that the Sandura Co. had violated section 5 of the FTC Act. Sandura was a small manufacturer of vinyl floor coverings in a field dominated by large concerns. It had almost been forced into bankruptcy by product failures and marketing difficulties and had no money to engage in national advertising. Distributors would not handle Sandura's product and conduct local advertising without closed territorial clauses. Sandura maintained that the closed territories were necessary to its very survival and to enable it to be an effective competitive force in a highly concentrated industry. Witnesses testified that Sandura could not have salvaged its business without this distribution system. The court noted that the restraints fostered interbrand competition and held them to be reasonable.⁴¹

V. Conclusion

There are two basic approaches the courts use under the antitrust laws. They may consider the legality of the restraint under the "rule of reason," or they may decide that a restraint is so utterly without justification as to be illegal per se. The government has followed the per se approach in dealing with territorial restrictions. At the present time, most businessmen have acceded to the government's position. The position of the Supreme Court is not yet clear, but the position of the lower federal courts appears to favor the "rule of reason" approach. The courts thus take into account the amount of interbrand competition within the relevant market, the purpose of the restraint, the financial status of the manufacturer and its relation to the distributor, and the effect of the restraint upon the consumer market. Neither of these positions, however, offers much guidance to the businessman who is debating whether or not to include such a clause in his franchise agreements.

Rather than analyzing vertical territorial allocations in the abstract, they should be categorized according to their effects before attempting to formulate legal solutions. The rule of reason certainly does not provide for easy administration, and it has the effect of leaving the businessman completely confused as to his legal position. The surest solution is to categorize the different territorial restrictions and then make a judgment as to which should be deemed legal and which illegal.⁴²

Vertical territorial restrictions can be divided into three different groups. The first is that by which the manufacturer assigns dealers to areas where they have primary responsibility. Under such an arrangement the manufacturer assigns a distributor to a designated territory and the distributor has primary responsibility to represent the manufacturer in that area. There may be clauses requiring the manufacturer's consent before the franchised dealers can relocate their place of business. This practice has been sanctioned by the Justice Depart-

40 *Sandura Co. v. FTC*, 339 F.2d 847 (6th Cir. 1964).

41 *Id.* at 856.

42 For a similar proposal in the field of labor law see 41 NOTRE DAME LAWYER 579 (1966).

ment,⁴³ and Justice Brennan seemed to approve the legality of such an arrangement in his concurring opinion in *White Motor Co.*⁴⁴ A second category of territorial restrictions requires the dealer to agree not to sell to customers outside his territory; he is subject to a "penalty" if he violates this agreement. This is the most difficult area of territorial restrictions. One can clearly see a restraint of trade and yet in some cases this restraint is reasonable. Rather than analyzing these restrictions under the "rule of reason" with its multitudinous complications, it might be better to follow the approach advanced in *United States v. Jerrold Electronics Corp.*⁴⁵ and hold these arrangements illegal unless it is shown that the unique circumstances of the industry require such restrictions. Such special circumstances may include the fact that the manufacturer is starting out in business or is marketing a new and risky product.⁴⁶ As a precautionary measure, such clauses should be avoided unless the manufacturer is quite certain he has a good justification for their use. The third general type of restraint is where the distributor agrees to sell only within his territory and to refer any customers who may approach him from outside of his territory to the dealer designated for their geographic area. Such a restraint seems totally unjustifiable and should be illegal *per se*.

The case law in this area is too sparse to draw any valid conclusions. The most one can do is speculate, but the foregoing analysis should be a conservative guide for the businessman and a reasonable blueprint for the courts to follow. The antitrust laws are intentionally flexible to meet any possible restraint that may arise, but this does not excuse the courts from providing reasonable guidelines so a manufacturer has some indication whether his course of conduct is legal or a violation of law.

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43 See *U.S. v. Bostitch Inc.*, 1958 Trade Cas. ¶ 69207 (D.R.I. 1958); *U.S. v. American Type Founders Co.*, 1958 Trade Cas. ¶ 69065 (D.N.J. 1958); *U.S. v. Rudolph Wurlitzer Co.*, 1958 Trade Cas. ¶ 69011 (W.D.N.Y. 1958); *U.S. v. Necchi Sewing Mach. Sales Corp.*, 1958 Trade Cas. ¶ 68957 (S.D.N.Y. 1958); *U.S. v. Seeburg Corp.*, 1957 Trade Cas. ¶ 68613 (N.D. Ill. 1957); *U.S. v. Philco Corp.*, 1956 Trade Cas. ¶ 68409 (E.D. Pa. 1956).

44 See note 24 *supra* and accompanying text.

45 *United States v. Jerrold Electronics Corp.*, 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961). See also *Switzer Bros., Inc. v. Locklin*, 297 F.2d 39 (7th Cir. 1961).

46 See note 24 *supra* and accompanying text. See also Note, *Newcomer Defenses: Reasonable Use of Tie-ins, Franchises, Territorials, and Exclusives*, 18 STAN. L. REV. 457 (1966).