Vanderbilt Law Review

Volume 22
Issue 3 *Issue 3 - April 1969*

Article 9

4-1969

# Recent Cases

Law Review Staff

# RECENT CASES

## Antitrnst—Informal Price-Information Exchanges Held Violative of Sherman Act

The United States brought a civil action to enjoin an alleged violation of section 1 of the Sherman Act[1] predicated upon the use by defendants,[2] manufacturers of corrugated containers, of an informal, oral system of price information exchange.[3] The Government contended that the defendants' exchange of current price information concerning specific sales to identified customers had the effect of restricting price competition.[4] Noting a downward trend in prices, defendants maintained that the record could not justify a finding that the mere exchange of price information had an unreasonable effect on pricing.[5] The district court held that the requesting and furnishing of price information by the defendants did not have the effect of restricting price competition.[6] On appeal to the United States Supreme Court, *held*, reversed. An informal exchange of current price information resulting in restricted price competition is a violation of section 1 of the Sherman Act. *United States* v. *Container Corporation of America,* 393 U.S. 333 (1969).

---

1. Sherman Antitrust Act § 1, *as amended*, 15 U.S.C. § 1 (1964): "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal. . . ."

2. Of the 51 producers of corrugated containers in the Southeast, the 18 defendants account for 90% of the market. United States v. Container Corp. of America, 393 U.S. 333, 342 (1969) (dissenting opinion).

3. Whenever price information was needed and was not available from another source, each defendant could request from a competitor his most recent price charged or quoted. The defendants demonstrated that they were free to withdraw from the agreement at any time and that exchanges of information were infrequent and irregular. Furthermore, such data was often available from various records or from the customers themselves. *Id.* at 335.

4. According to plaintiff's line of reasoning, the restricted competition resulted in a stabilization of prices. "[I]n terms of market operations, stabilization is but one form of manipulation." United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 223 (1940).

5. The trend of corrugated container prices has been downward with capacity exceeding demand from 1955 to 1963, the period covered by the complaint. The defendant contended that falling prices, coupled with an industry expansion of 30 manufacturers in 1955 to 51 manufacturers in 1963, indicated that competition had not been restrained. Furthermore, "an abundance of raw materials and machinery makes entry into the industry easy with an investment of $50,000 to $75,000." United States v. Container Corp. of America, 393 U.S. 333, 336 (1969).

6. United States v. Container Corp. of America, 273 F. Supp. 18, 67 (M.D.N.C. 1967). The district court concluded that the Government had not met its burden in producing evidence

A successful prosecution for violation of section 1 of the Sherman Act requires the finding of a "contract, combination . . . or conspiracy, in restraint of trade." In *Standard Oil of New Jersey v. United States*,[7] the Supreme Court held that a "rule of reason" was determinative of the legality of restraints of trade. Simply stated, the rule of reason condemns agreements which are unreasonably restrictive of competitive price conditions.[8] *Board of Trade of Chicago v. United States*[9] modified the rule of reason by making it clear that proof of power, purpose, and effect was required to establish the illegality of a price-fixing agreement under the Sherman Act. Therefore, the parties to an illegal price-fixing agreement were required to have the power and intent to affect price, coupled with success in reaching their goal. Subsequently, in a series of four decisions concerning exchanges of price information,[10] the Court relaxed the evidentiary requirement of a purpose to fix prices and

---

to support the inference that defendants exchanged price information "for the purpose of maintaining substantially identical price quotations to specific customers or minimizing the amount of any price reductions to be offered to such customers." *Id.* The district court analogized the instant case to the fact situations presented in Cement Mfrs. Protective Ass'n v. United States, 268 U.S. 588 (1925), and Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925).

7. 221 U.S. 1 (1911). It has been suggested that Mr. Chief Justice White, who delivered the majority opinion, established a test of reasonableness "to alleviate and yet preserve the previously misdirected impetus given the Sherman Act by Justice Peckham." Morris, *Is Price-Fixing Per Se Reasonable? A Discussion*, 47 KY. L.J. 63, 65 (1958).

8. 1955 ATT'Y GEN. NAT'L COMM. ANTITRUST REP. 5.

9. 246 U.S. 231 (1918). Mr. Justice Brandeis upheld a grain-exchange rule fixing prices at the closing bid on grain "to arrive." He concluded that: "the true test of legality is whether the restraint imposed is such as merely regulates and perhaps thereby promotes competition or whether it is such as may suppress or even destroy competition. To determine that question the court must ordinarily consider the facts peculiar to . . . the nature of the restraint and its effect, actual or probable." *Id.* at 238. *But see* Dr. Miles Medical Co. v. Peck & Sons, 220 U.S. 373 (1911), where the language seemed to condemn all resale price-maintenance agreements. Peppin, *Price-Fixing Agreements Under the Sherman Anti-Trust Law*, 28 CALIF. L. REV. 667, 702-04 (1940).

10. Cement Mfrs. Protective Ass'n v. United States, 268 U.S. 588 (1925) (upholding the distribution by an association of information pertaining to specific job contracts to avoid possibility of fraud); Maple Flooring Mfrs. Ass'n v. United States, 268 U.S. 563 (1925) (upholding the circulation without comment of honest cost figures among a group of lumber manufacturers); United States v. American Linseed Oil Co., 262 U.S. 371 (1923) (condemning a basing-point system of price-fixing); American Column & Lumber Co. v. United States, 257 U.S. 377 (1921) (condemning the distribution of elaborate statistics and "suggestions" as to prices by an association of lumber dealers). One writer has suggested that the fundamental distinction between the *American Linseed* and *American Column* cases as opposed to the *Maple Flooring* and *Cement Mfrs.* cases is that "in the former the parties to the combination were projecting themselves into the running of each other's business to the detriment of the buying public, whereas in the latter cases the parties to the agreement were trying to conduct their

focused on the power to affect market forces and on the actual effect produced.[11] An exception to the rule of reason was forged in the significant decision of *United States v. Trenton Potteries Co.*[12] in which Mr. Justice Stone, relying on a "power" interpretation, adopted a per se rule,[13] which eliminated a balancing of economic factors and their possible economic effects.[14] Thus, *Trenton Potteries* stands for the proposition that price-fixing is unreasonable per se if the parties have the power to affect the market.[15] The "power" interpretation has been affirmed in two subsequent decisions,[16] both of which upheld the agreements in question. The Court concluded that the intent to fix prices was not illegal per se if the parties were without power to affect market prices. Until 1940, therefore, the Court did not condemn price-fixing agreements among parties who did not have the power to affect market prices. That year, however, in *United States v. Socony-Vacuum Oil Co.*,[17] the Court broadly expanded the scope of the price-fixing rule, concluding that: (1) the rule applied to all arrangements intended to affect price;[18] (2) a showing of market control was not necessary;[19] and (3) a showing of the reasonableness of fixed prices or of ruinous competition was not a

businesses intelligently by seeking information which, while helpful to them, was not harmful to competitors or to the buying public." E. HODGES, ANTITRUST ACT AND THE SUPREME COURT 43-44 (1941).

11. *See* Comment, *The Per Se Illegality of Price-Fixing—Sans Purpose, Power, or Effect*, 19 U. CHI. L. REV. 837, 853-54 (1952).

12. 273 U.S. 392 (1927).

13. *Id.* at 398: "[U]niform price-fixing by those controlling in any substantial manner a trade or business in interstate commerce is prohibited by the Sherman Law, despite the reasonableness of the particular prices agreed upon." The *Board of Trade of Chicago* case was distinguished as affecting "only a small proportion of the commerce in question." *Id.* at 401.

14. *See* Morris, *supra* note 7, at 63. Clearly, the per se approach lightened the Government's burden in establishing a price-fixing agreement as a restraint of trade.

15. *See* Comment, *supra* note 11, at 855.

16. In Standard Oil Co. (Indiana) v. United States, 283 U.S. 163 (1931), the Court upheld an agreement fixing royalty rates among owners of conflicting patents. The Court found no evidence of "control of the entire industry as would make effective the alleged domination of a part." *Id.* at 179. In Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933), the Court upheld a common selling agency with price-fixing powers on the theory that the agency did not have the power to affeet the market price of coal. *Id.* at 373.

17. 310 U.S. 150 (1940). *See* 1 S. WHITNEY, ANTITRUST POLICIES ch. 3 (1958).

18. 310 U.S. 150, 225 n.59 (1940). For a discussion of *Socony*, see Rahl, *Price Competition and the Price-Fixing Rule—Preface and Perspective*, 57 NW. U.L. REV. 137, 141 (1962).

19. 310 U.S. 150, 224-25 n.59 (1940): "But that does not mean that both a purpose and a power to fix prices are necessary for the establishment of a conspiracy under § 1 of the Sherman Act. . . . [A] conspiracy to fix prices violates § 1 of the Act though no overt act is shown, though it is not established that the conspirators had the means available for

defense.[20] Although the elimination of the requirement of market control in *Socony* was not essential to the decision since the Government had established that respondents did have the power to affect prices,[21] it is precisely this point which has increased the scope of the price-fixing rule.[22] Based on a belief that price competition is a market force, the rule is applicable in a wide variety of situations.[23] By eliminating market power considerations, *Socony* had the affect of making purpose to fix prices determinative of the legality of an agreement.[24] Furthermore, the Supreme Court has repeatedly held that in the light of section 1 of the Sherman Act, price-fixing is illegal per se.[25] On the other hand, absent a purpose to fix prices, a separate line of cases has supported the rule of reason approach of balancing economic factors.[26]

In the instant case, the Court looked to the reciprocal nature of the price-information agreement[27] in order to find concerted actions, as required by section 1 of the Sherman Act.[28] After this initial

accomplishment of their objective, and though the conspiracy embraced but a part of the . . . commerce in the commodity." *See* Rahl, *supra* note 18.

20. 310 U.S. 150, 221 (1940). *See* Rahl, *supra* note 18.

21. United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 224 n.59 (1940).

22. The Court concluded that a conspiracy to fix prices violates § 1 of the Sherman Act even though no overt act is proven. Consequently, market control is irrelevant if an intent to fix prices is demonstrated. United States v. Socony-Vacuum Oil Co., 310 U.S. 150, 225-26 n.59 (1940).

23. See Rahl, *supra* note 18 for a compilation of cases. It is important to note that the rule also applies to agreements to lower prices. American Tobacco Co. v. United States, 328 U.S. 781 (1946).

24. The agreement itself, therefore, has become the focal point of investigation. If the thrust of the agreement indicates an intention to fix prices, the per se rule will apply. *See generally* Rahl, *Conspiracy and the Antitrust Laws*, 44 ILL. L. REV. 743, 752 (1950); Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusals to Deal*, 75 HARV. L. REV. 655 (1962).

25. *E.g.*, Northern Pac. Ry. v. United States, 356 U.S. 1 (1958); United States v. New Wrinkle, Inc., 342 U.S. 371 (1952); United States v. Paramount Pictures, Inc., 334 U.S. 131 (1948); United States v. Frankfort Distilleries, Inc., 324 U.S. 293 (1945).

26. *E.g.*, Appalachian Coals, Inc. v. United States, 288 U.S. 344 (1933); Standard Oil Co. (Indiana) v. United States, 283 U.S. 163 (1931); Board of Trade of Chicago v. United States, 246 U.S. 231 (1918).

27. Mr. Justice Douglas, who delivered the majority opinion, reasoned that each defendant furnished data to his competitor with the expectation that he would be furnished with similar information upon his request. United States v. Container Corp. of America, 393 U.S. 333, 335 (1969). The district court, however, had previously held that the Government had failed to establish the existence of an agreement to exchange price information. The district court relied upon the infrequency and lack of uniformity of the information furnished in making its decision. United States v. Container Corp. of America, 273 F. Supp. 18, 58-59 (M.D.N.C. 1967).

28. Section 1 requires a finding of a "contract, combination . . . or conspiracy. . . ." Sherman Antitrust Act § 1, *as amended*, 15 U.S.C. § 1 (1964).

determination, the Court addressed itself to the question of whether the exchange of price information had the effect of restraining price competition. In this regard, the Court examined the agreement's effect on pricing during the period covered by the complaint. Although prices were falling, the Court concluded that the reciprocal exchange of current prices had a stabilizing effect on the prices at the downward level.[29] The Court reasoned that knowledge of a competitor's price encouraged the defendants to match that price, thus reducing price competition. Stabilizing prices, as well as raising them, is banned by section 1 of the Sherman Act.[30] The Court relied upon *United States v. Socony-Vacuum Oil Co.*[31] for the proposition that "interference with the setting of price by free market forces is unlawful *per se.*"[32] The Court conceded that in some markets price-information exchanges will have no effect on a truly competitive price; however, in the instant case, the exchange of price data resulted in price uniformity.[33] Therefore, the Court concluded that "the inferences are irresistible that the exchange of price information has had an anticompetitive effect in the industry, chilling the vigor of price competition."[34] Mr. Justice Fortas, in a concurring opinion,[35] reasoned that absent a per se violation, circumstances must show an actual effect on pricing. Justice Fortas concluded that an actual effect had been established by the Government, thereby making section 1 applicable. Mr. Justice Marshall, dissenting,[36] found neither a per se

29. United States v. Container Corp. of America, 393 U.S. 333, 336-37 (1969).

30. *See* note 4 *supra*.

31. 310 U.S. 150 (1940).

32. 393 U.S. 333, 337 (1969).

33. In making this conclusion, the Court indicated that the following factors were relevant: the corrugated container industry is an oligopoly dominated by relatively few sellers; the product is fungible; the demand is inelastic; and the competition for sales is price. *Id.*

34. *Id.* "Price is too critical, too sensitive a control to allow it to be used even in an informal manner to restrain competition." *Id.* at 338.

35. *Id.* (Mr. Justice Fortas, concurring). Absent a per se violation, the plaintiff must establish that the practice resulted in an unreasonable restraint on trade. Justice Fortas reasoned that the evidence "although not overwhelming," was sufficient to show an actual effect on pricing. "[D]efendants' tacit agreement to exchange information about current prices to specific customers did in fact substantially limit the amount of price competition in the industry. That being so, there is no need to consider the possibility of a *per se* violation." *Id.* at 340.

36. *Id.* (Mr. Justice Marshall dissenting). Mr. Justice Marshall would have affirmed the findings of the district court that the corrugated container industry was highly competitive. The downward trend of prices and the increase in the number of manufacturers would seem to support the findings of the district court. Justice Marshall did not accept the Government's contention that "prices would have been more unstable and would have fallen faster without price information." *Id.* at 346.

violation nor a restraint on competition. Justice Marshall noted that price-information exchanges have been refused per se treatment in the past, and after an examination of the record, concluded that the Government had not proved its case.[37]

A cursory reading of the instant case would suggest that the Supreme Court has extended per se reasoning to the practice of price-information exchange. Mr. Justice Douglas, author of the *Socony* opinion, indicated in the instant case that the exchange of current prices resulted in a reduction of price competition which is unlawful per se.[38] Furthermore, Justice Douglas did not weigh economic factors relating to the reasonableness of the agreement, but rather condemned the arrangement for having any effect on price.[39] However, it is submitted that there is evidence of underlying reasoning in the instant decision which indicates that the Court employed more than a simple per se approach. Relative to price-information exchanges, it appears that the Court has made academic the distinction between the per se approach and the rule of reason approach. By measuring factual situations against certain criteria, the result reached using either approach is practically uniform. These criteria are purpose, effect and justification. If an examination of a price-exchange agreement yields a finding that the parties to the agreement intended to fix prices, the Court, relying upon *Socony*, will find a per se violation. Therefore, the defendant must establish at the outset of his case that the agreement was not intended to fix prices, since a finding of improper purpose will necessarily result in an adverse holding. In the instant case, the Court found no express purpose to fix prices and therefore considered the effect and justification of the agreement. It is in this area that the distinction between per se and rule of reason is eliminated. If the agreement affects price, it will be declared illegal unless an affirmative justification is demonstrated. Absent a showing of justification, the agreement is both unlawful per se and unreasonable under the rule of reason approach. In the instant case,

37. *Id.* at 344, 347. Justice Marshall believed that the information was used to reach individual price decisions and not used as a basis to fix prices. Id. at 394.

38. Citing *Socony* for the proposition that "interference with the setting of price by free market forces is unlawful *per se*," Justice Douglas concluded that the reduction of price competition brought the instant case within the ban. *Id.* at 337.

39. The idea that price competition is the "central nervous system" of the economy has been challenged: "the concept of competition that has grown out of the antitrust laws is not confined to price competition, but accords a place to competition as affecting productive techniques and quality and design of products." P. CLARK, COMPETITION AS A DYNAMIC PROCESS 47 (1961).

defendants argued that the agreement did not have an effect on competition,[40] not that the agreement was justified.[41] Finding an effect on price and no affirmative justification, the Court held the agreement illegal. At this point, the per se and rule of reason approaches merge, since the application of either to the instant agreement yields an identical result.

## Conflict of Laws—"Contacts" Doctrine Applied to Supplement Federal Maritime Law in Diversity Action

Plaintiff brought a diversity action in federal court to recover for the death of plaintiff's decedent in an airplane crash occurring in the navigable waters of Boston harbor. A round-trip ticket between Philadelphia and Boston had been purchased by the deceased in Pennsylvania, his domicile and the state in which his estate was administered. The District Court for the Eastern District of Pennsylvania found that the defendant's negligence was the proximate cause of decedent's death. On the question of damages, plaintiff argued that the Pennsylvania Wrongful Death and Survival Act should govern, since Pennsylvania had the most significant contacts with the parties and, consequently, the most significant interest in having its law applied.[1] Defendant contended that since the crash occurred in Massachusetts, the limited liability provisions of the Massachusetts wrongful death law should apply under the traditional choice of law rule of lex loci delicti.[2] The district court adopted the

40. The dissent made a convincing argument that competition was not affected by the agreement. 393 U.S. 333, 342-47 (1969).

41. Admittedly, justifications are quite limited and need careful definition. *See generally* Turner, *Cooperation Among Competitors*, 61 Nw. U.L. Rev. 865, 869-70 (1967).

---

1. Pennsylvania's Wrongful Death and Survival Acts allow recovery of the present worth of the anticipated value of the decedent's estate as it would exist at the end of a normal lifetime. Pa. Stat. Ann. tit. 12, §§ 1601-1604 (1953) and Pa. Stat. Ann. tit. 20, § 320.601 (1953).

Plaintiff also argued in the original trial and on rehearing that there was a breach of contract between decedent and the airlines. The court disposed of defendant's contention that there was no contractual relationship between the parties by indicating that defendant's liability was governed by principles of negligence, and not of contract, because the action was for a negligent breach of contract and not a simple breach of contract. *See* Griffith v. United Air Lines, Inc., 416 Pa. 1, 203 A.2d 796 (1964).

2. The Massachusetts statutes concerning liability for wrongful death and the survival of causes of action, in effect at the time of the accident, made one whose negligence had caused the death of another liable "in damages in the sum of not less than two thousand nor more than twenty thousand dollars, to be assessed with reference to the degree of his culpability." Recovery

contacts approach and refused to apply the restrictive Massachusetts law, thus permitting the jury to award full compensation for the loss under the Pennsylvania law. The Third Circuit Court of Appeals reversed the damage award and held that since the tort occurred in navigable waters, the federal maritime law governed liability for the tort.[3] This federal maritime law, held the circuit court, must be supplemented by state law in defining the rights of dependents to recover for wrongful death. In choosing which state's law is to be used to provide this supplementation, the circuit court applied the choice of law rule which the federal courts have traditionally applied in the maritime tort area—the law of the state in which the tort occurred shall govern. On rehearing, *held,* reversed. Where state law is required to supplement federal maritime law in determining the rights of dependents to recover for wrongful death, the law of the state which has the most significant contacts with the action will be applied. *Scott v. Eastern Air Lines, Inc.,* 399 F.2d 14 (3d Cir. 1968).

Historically, maritime law has made no provision for recovery in wrongful death cases,[4] and Congress has provided a legislative remedy for this deficiency only when death occurs on the high seas.[5] The courts have construed the congressional act to mean that admiralty jurisdiction applies not only to the high seas, but also to those waters navigable in fact, regardless of whether or not they are subject to the ebb and flow of the tide.[6] Where no specific statutory language can be found to govern the rights of parties arising out of a tortious act occurring within the scope of federal maritime jurisdiction, the courts have applied a simple rule of "borrowing" under which maritime law will accord relief neither more nor less extensive than would be enjoyed under the law of the state in whose territorial waters the tort occurred.[7] As a consequence, admiralty law has traditionally been supplemented by the law of the state of the tort. However, recent developments in choice-of-law rules have signified a trend away from

---

of certain expenses incurred as a result of the wrong were also permitted. MASS. GEN. LAWS ANN. ch. 228, § 1(2) (1955) and MASS. GEN. LAWS ANN. ch. 229, § 2 (1955).

3. Weinstein v. Eastern Airlines, Inc., 316 F.2d 758 (3d Cir.), *cert. denied,* 375 U.S. 940 (1963), involved the same set of facts as the instant case and the court ruled that the case was within the admiralty jurisdiction of the United States.

4. *See* The Harrisburg, 119 U.S. 199 (1886). For an extensive discussion, see Currie, *State Laws in Maritime Death Cases,* 21 VAND. L. REV. 297 (1968).

5. 46 U.S.C. § 761 (1964).

6. Insurance Co. v. Dunham, 78 U.S. (11 Wall.) 1 (1870).

7. The Tungus v. Skovgaard, 358 U.S. 588 (1959). *See also* Hess v. United States, 361 U.S. 314 (1960); Western Fuel Co. v. Garcia, 257 U.S. 233 (1921).

the traditional application of the choice-of-law theory of lex loci delicti and toward application of the law of the place with the most substantial interest in the resolution of the issue involved.[8] This trend has been reinforced by judicial indications that a state with some substantial interest in the application of its own laws to the dispute can constitutionally apply its laws without running afoul of due process or full faith and credit requirements.[9] Specifically, the trend has extended to cases involving international claims under federal maritime law where several times the application of the rule of lex loci delicti has been ignored by the courts in favor of a "contacts" approach, particularly where one state or nation obviously has a more significant interest in the occurrence and the parties as to the particular issue involved than has another. One such case, *Lauritzen v. Larsen,*[10] analyzed various factors which generally influence the choice of law governing a maritime tort claim. Premising their argument on the idea that conflicts of laws should be resolved by ascertaining and valuing points of contact relating the transaction and the nations whose competing laws are involved, the *Lauritzen* court indicated several such points of contact to be weighed in determining which state has the most significant governmental interest in applying its own law: the law of the flag; allegiance or domicile of the injured; allegiance of the defendant shipowner; place of contract; inaccessibility of foreign forum; the law of the forum; and the place of the wrongful act.[11] That court rejected the theory that the place of the

---

8. *See* Babcock v. Jackson, 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963). This is generally a rejection of the "vested rights" doctrine which holds that the right to recover for a foreign tort owes its creation to the law of the place where the injury occurred. For views opposed to the vested rights theory, see Cavers, *A Critique of the Choice-of-Law Problem*, 47 HARV. L. REV. 173 (1933); Cheatham, *American Theories of Conflict of Laws: Their Role and Utility*, 58 HARV. L. REV. 361 (1945); Cheatham and Reese, *Choice of the Applicable Law*, 52 COLUM. L. REV. 959 (1952); Leflar, *Choice-Influencing Considerations in Conflicts Law*, 41 N.Y.U.L. REV. 267 (1966).

9. *E.g.*, Pearson v. Northeast Airlines, Inc., 309 F.2d 553 (2d Cir. 1962). This case also involved the Massachusetts Wrongful Death Act. The court indicated that all the issues involved should be weighed and should include the conduct of the parties, the extent of their liability, the period during which the liability may be sued upon, state immunities and insurance procedures, and the contacts of the states with the transaction. As a result of this weighing process, the court could apply the law of the state with the most significant contacts to further a policy of its own even if it were contrary to some provision of the locus statute which created the cause of action.

10. 345 U.S. 571 (1953) (case involving the issue of applying American (Jones Act), Danish, or Cuban law to the claim of a Danish seaman who, after joining a Danish vessel in an American port, was injured in the harbor of Havana).

11. *Id.* at 583.

wrongful act was necessarily a predominant factor in determining the law governing maritime tort claims. Another case involving international problems, *Romero v. International Terminal Operating Co.*,[12] also discounted the importance of the place of the injury in determining which state's law should apply. The approach of isolating issues and weighing contacts to determine which jurisdiction has the most significant interest in the resolution of a particular issue has been adopted by many jurisdictions[13] and given support by *The Tentative Draft of Restatement (Second) of Conflict of Laws.*[14]

In its initial hearing of the case, the instant court merely adopted the traditional rule and applied the law of the state within the boundaries of which the maritime tort occurred.[15] However, on rehearing, the court first reconsidered the issue of contractual obligation and found that even though there was a "contract of carriage," this contract was for non-negligent carriage and, therefore, an action would lie either in tort or in contract. Consequently, the court stated that the fact that a possible contract action existed for a breach of contract of non-negligent carriage would not provide a basis for the disallowance of a tort claim under federal maritime law, and proceeded to reanalyze its previous holding so as to determine the choice of law rule it should apply to determine which state's statute

12. 358 U.S. 354 (1959). Following this decision, the Fourth and Fifth Circuits have based their holdings on factors such as nationality rather than place of injury. McClure v. United States Lines Co., 368 F.2d 197 (4th Cir. 1966); Symonette Shipyards, Ltd. v. Clark, 365 F.2d 464 (5th Cir. 1966), *cert. denied*, 387 U.S. 908 (1967).

13. For cases following the lead of Babcock v. Jackson, 12 N.Y.2d 473, 191 N.E.2d 279, 240 N.Y.S.2d 743 (1963), *see, e.g.*, Reich v. Purcell, 67 Cal. 2d. 551, 432 P.2d 727, 63 Cal. Rptr. 31 (1967); Hopkins v. Lockheed Aircraft Corp., 201 So. 2d 743 (Fla. 1967); Wartell v. Formusa, 34 Ill.2d 57, 213 N.E.2d 544 (1966); Wessling v. Paris, 417 S.W.2d 259 (Ky. 1967); Griffith v. United Air Lines, Inc., 416 Pa. 1, 203 A.2d 796 (1964); Clark v. Clark, 107 N.H. 351, 222 A.2d 205 (1966). *See also* 21 VAND. L. REV. 266 (1968), *and* note 8 *supra*.

14. RESTATEMENT (SECOND) OF CONFLICT OF LAWS (Tent. Draft No. 9, 1964). Note especially § 379, which sets forth guidelines to assist in determining which state has the most significant contacts. These guidelines include: "(1) the local law of the state which has the most significant relationship with the occurrence and with the parties determines their rights and liabilities in tort. (2) Important contacts that the forum will consider in determining the state of most significant relationship include: (a) the place where the injury occurred, (b) the place where the contact occurred, (c) the domicile, nationality, place of incorporation and place of business of the parties, and (d) the place where the relationship, if any, between the parties is centered. (3) In determining the relative importance of the contacts, the forum will consider the issues, the character of the tort, and the relevant purposes of the tort rules of the interested states."

15. "If the long and consistently accepted and applied rule of maritime law which requires that the federal right to recovery in such cases as this be measured by the provisions of Massachusetts law is to be modified, that change should be made by the Supreme Court." 399 F.2d 14, 18 (3d Cir. 1968).

should govern the damage award.[16] The court rejected defendant's argument that, since the underlying policy of the Massachusetts Wrongful Death Act is to deter the commission of tortious acts in Massachusetts, Massachusetts had a substantial interest in the application of her law. The court reasoned that this broad policy of Massachusetts would not be impinged by application of the more liberal Pennsylvania rule.[17] The court also held that the application of Pennsylvania law violated neither the due process nor the full faith and credit clauses of the United States Constitution, because Pennsylvania had substantial contact with the activity in question and thus a sufficient basis to enable it to apply its own law.[18] Restating its previous holding that when fatal injuries are sustained upon navigable waters maritime principles will govern the tort aspects of the case,[19] the court rejected the defendant's contention that the law of the place of the tort should be the choice of law rule applied in choosing which state's wrongful death laws will supplement maritime law.[20] Also rejecting defendant's argument that the court should follow recognized judicial holdings that the several states had the power to provide for claims arising out of fatal injuries sustained in *their* respective waters,[21] the court indicated that the necessary guidelines for the proper disposition of the question lay in the significant contacts approach of *Lauritzen v. Larsen*[22] and similar cases.[23] Analyzing the

16. *Id.* at 20-24. The court noted that Weinstein v. Eastern Airlines, Inc., 316 F.2d 758 (3d Cir.), *cert. denied*, 375 U.S. 940 (1963), distinguished tort claims which are maritime in nature and contract claims which are not. The recognition of a diversity claim for breach of contract in no way preempts the application of federal maritime law to the tortious aspects of the claim. *See* note 1 *supra*.

17. 399 F.2d at 22-23. The defendant had argued that the Massachusetts Wrongful Death Act's underlying policy was to deter potential tortfeasors from engaging in tortious conduct in Massachusetts. The court found this argument unpersuasive in that liability limited to $20,000 could not be as great a deterrent to a tortfeasor as an unlimited liability similar to that of the Pennsylvania statute.

18. *Id.* at 23. *See* International Shoe Co. v. Washington, 326 U.S. 310 (1945); McGee v. International Life Ins. Co., 355 U.S. 220 (1957).

19. Weinstein v. Eastern Air Lines, Inc., 316 F.2d 758 (3d Cir.), *cert. denied*, 375 U.S. 940 (1963).

20. 399 F.2d 14, 25 (3d Cir. 1968). Defendant sought support for its contentions in the fact that it was unable to find one reported case in the Third Circuit involving death upon state navigable waters wherein the law of the state in which the tort occurred was not applied. However, the instant court indicated that in none of the cases cited by the defendant was a choice of law question considered. The one exception was The H.S., Inc. No. 72, 130 F.2d 341 (3d Cir. 1942), in which the court noted in dictum that the law of the state of the tort should be applied in recovery for a maritime tort under a state death statute.

21. 399 F.2d at 26. *See also* The Tungus v. Skovgaard, 358 U.S. 588 (1959).

22. 345 U.S. 571 (1953).

23. Romero v. International Terminal Operating Co., 358 U.S. 354 (1959); McClure v.

circumstances of the case, the court found that the most significant relations and contacts in the case were in Pennsylvania and not Massachusetts.[24] Therefore, having determined that the law of the place with the most significant contacts with the transaction should be applied, the court found that the maritime law was correctly supplemented by the Pennsylvania Wrongful Death and Survival Act.[25] Buttressing its decision, the court noted that admiralty courts, like state courts, have an obligation to rcfrain from application of an inappropriate or inequitable rule and that to apply the Massachusetts law on damages merely because the airplane happened to crash into that state's navigable waters would be both inappropriate and inequitable since the contacts with Pennsylvania law were much more significant on the damages issue.[26]

In view of the growing trend toward the "significant contacts" approach in the field of conflict of laws, the instant court reached a sound decision. It is submitted that the balancing of individual and governmental interests here led to not only a sound, but also a just result, particularly insofar as the tort aspects of the case are concerned. Since torts are rarely planned and since "significant contacts" will normally fall into reasonably clear groupings, there is no longer a place for arguing that predictability of result has been sacrificed. In the instant case, the flexibility afforded the court by adoption of the significant contacts approach allowed it to avoid the patent injustice of applying the Massachusetts limited liability law to the damage claim of Pennsylvania domiciliaries for the death of their decedent Pennsylvania domiciliary. Clearly, the goal of justice is best

United States Lines, Co., 368 F.2d. 197 (4th Cir. 1966). For summaries of these cases, see notes 10-12 and accompanying text *supra*.

24. The contract was made in Pennsylvania. Decedent's domicile and the administration of his estate were there. Only the site of the injury was in Massachusetts.

25. 399 F.2d at 28.

26. *Id.* at 29. An interesting concurring opinion by Judge Seitz advocated application of the state choice-of-law rule to all the claims, because the action was on the law side of the court under diversity jurisdiction, and thus outside of admiralty jurisdiction. Judge Seitz noted that even though a right of action under maritime law arose as a result of the accident and could have been asserted under the admiralty jurisdiction of the district court, it did not follow that recognition of a state common-law right of action entertained under diversity jurisdiction was thereby foreclosed. *See* 28 U.S.C. § 1333 (1964). Judge Seitz stated that there was no overriding concern for the exclusive application of maritime law and that the recognition of a state law claim would in no way foreclose the assertion of the maritime rights of the plaintiff in the event he should elect to have the matter determined by such principles. In asserting his state law rights, there seems to be no reason why plaintiff's action could not be maintained as a state law action under the district court's diversity jurisdiction. Scott v. Eastern Air Lines, Inc., 399 F.2d 14, 29-30 (3d Cir. 1968) (concurring opinion).

served by application of the Pennsylvania damage rule. The mere fortuity of death in another state should not control the rights of the surviving parties, all of whom have intimate contacts with Pennsylvania and who may be forced to look to that state's beneficence should their claim be in large measure denied. It may hardly be contended that the plaintiffs here were not among the intended beneficiaries of the Pennsylvania damage rule; thus, application of the foreign statute would frustrate not only the governmental intent of Pennsylvania, but also the theoretical intent of the plaintiffs, who by representation, favored such a rule. Although these arguments are substantially similar to those favoring adoption of the "significant contacts" approach in other cases, the instant court is to be commended nonetheless for laying to rest the vested rights and lex loci delicti rules in yet another area of the law.

## Constitutional Law—Fourteenth Amendment Prohihits Extended Postponement of Parole Consideration for State Iumate When Made on the Basis of an Unreliahle Factual Determiuation

Plaintiff, a state prison inmate, sought declaratory and injunctive relief in federal court under section 1 of the 1871 Civil Rights Act[1] against defendants, the Illinois state penitentiary warden and parole board chairman, after their decision in 1963 to postpone his scheduled parole consideration for eleven months. The decision was based on information from prison guards that plaintiff had possessed contraband in his cell.[2] Plaintiff alleged in his complaint that the "contraband" was a powdered breakfast drink legally available to all prisoners and that his request for an analysis of the powder was denied. Defendant's motion to dismiss the complaint for failure to

1. 42 U.S.C. § 1983 (1964): "Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Tcrritory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress."

2. The postponement was from February, 1968, until January, 1969. Plaintiff contended that this postponement of parole consideration was a cruel and unusual punishment under the eighth amendment. However, the court rclied on the illegality of the procedure used to postpone parole rather than the severity of the punishment imposed on plaintiff to determine what substantive legal right had becn violated. Therefore, even though plaintiff did not specifically assert a violation of the equal protection clause, the court hy liberally construing the complaint ascertained that an equal protection violation had occurred.

state a justiciable claim was granted by the district court. On appeal to the United States Court of Appeals, *held,* reversed and remanded. The equal protection clause of the fourteenth amendment is violated when a state prisoner is denied parole consideration on the basis of facts unreliably determined by prison officials. *Campbell v. Pate,* 401 F.2d 55 (7th Cir. 1968).

Courts have recognized that prisoners retain certain civil and constitutional rights during incarceration.[3] This judicial philosophy has become known as the "retained right" doctrine. However, courts have also recognized that incarceration necessitates limitations on and withdrawal of certain rights of prisoners[4] for purposes of effective penal administration[5] and particularly for purposes of disciplinary control.[6] Therefore, while recognizing that prisoners retain rights

3. .Coffin v. Reichard, 143 F.2d 443, 445 (6th Cir. 1944), *cert. denied,* 355 U.S. 887 (1945): "A prisoner retains all the rights of an ordinary citizen except those expressly, or by necessary implication, taken from him by law." *Accord,* Jackson v. Bishop, 268 F. Supp. 804 (E.D. Ark. 1967) (constitutional punishment with leather strap may be unconstitutionally administered); Talley v. Stephens, 247 F. Supp. 683 (E.D. Ark. 1965) (equal protection and due process available despite loss of other rights and privileges).

4. Price v. Johnson, 334 U.S. 266, 285 (1948): "Lawful incarceration brings about the necessary withdrawal or limitation of many privileges and rights, a retraction justified by the considerations underlying our penal system." *Accord,* Childs v. Pegelow, 321 F.2d 487 (4th Cir. 1963), *cert. denied,* 376 U.S. 932 (1964); Ruffin v. Commonwealth, 62 Va. (21 Grattan) 790 (1871) (as a consequence of his crime, convict not only forfeits his liberty, but all his personal rights except those which the law in its humanity accords him).

5. Talley v. Stephens, 247 F. Supp. 683, 686 (E.D. Ark. 1965): "[C]onvicts must be disciplined, and prison authorities must be given wide latitude and discretion in the management and operation of their institutions. . . . [T]hey cannot undertake to review every complaint made by a convict about his treatment while in prison." *Accord,* Cole v. Smith, 344 F.2d 721 (8th Cir. 1965) (absent clear showing of violation of a constitutional right, state prison administration will not be reviewed by the courts). For federal court policy in regard to federal penal administration, see, *e.g.,* Sutton v. Settle, 302 F.2d 286 (8th Cir. 1962); Williams v. Steele, 194 F.2d 32 (8th Cir. 1952); Garcia v. Steele, 193 F.2d 276 (8th Cir. 1951).

6. Of course, administration and discipline must be interrelated for proper penal functioning. In Weller v. Dickson, 314 F.2d 598, 602 (9th Cir. 1963), the court emphasized that it knew "from sad experience with habeas corpus and 2255 [18 U.S.C. § 2255 (1964)] cases that imprisoned felons are seldom, if ever, deterred by the penalties of perjury. They do not hesitate to allege whatever they think is required in order to get themselves even the temporary relief of a proceeding in court . . . . The disruption of prison discipline that the maintenance of such suits, at government expense, can bring about is not difficult to imagine." *Accord,* Roberts v. Barbosa, 227 F. Supp. 20 (S.D. Cal. 1964). *See also* Negrich v. Hohn, 379 F.2d 213 (3rd Cir. 1967); Snow v. Gladden, 338 F.2d 999 (9th Cir. 1964). In Edwards v. Sard, 250 F. Supp. 977 (D.D.C. 1966), the court held that even though racial discrimination was present in the prison dormitory system, it was not unconstitutional in light of social unrest and conflict, because full integration would jeopardize the security of the institution. *But see* Washington v. Lee, 263 F. Supp. 327 (M.D. Ala. 1966), *aff'd per curiam,* 390 U.S. 333 (1968), where complete desegregation was ordered within one year in the Alabama jail systems.

which may be judicially enforced, courts have been extremely reluctant to interfere with federal[7] or state[8] prison administration through the process of judicial review. Thus prison officials have been permitted to impose on prisoners such discretionary restrictions as they considered necessary to maintain order within the prison walls.[9] This judicial reluctance to interfere with penal management has become the second philosophy recognized in the court-prison relationship, the "hands-off" doctrine.[10] While the two concepts, the "retained rights" and the "hands-off" doctrines, are theoretically concise, difficulties have arisen in particular situations when the federal courts have had to ascertain which rights confined individuals in fact retained.[11] The courts have generally held that some rights are so fundamental that when they are abridged the judiciary should consider a complaint justiciable. Thus prisoners have obtained court review of their claims when they have alleged an abuse or denial of the rights to: religious freedom,[12] access to courts for redressing legal

---

7. *E.g.*, Tilden v. Pate, 390 F.2d 614 (7th Cir. 1968); Negrich v. Hohn, 379 F.2d 213 (3rd. Cir. 1967); People v. Bibb, 252 F.2d 217 (7th Cir. 1958); United States *ex rel.* Atterbury v. Ragen, 237 F.2d 953 (7th Cir. 1956); United States v. Radio Station WENR, 209 F.2d 105 (7th Cir. 1953); Nichols v. McGee, 169 F. Supp. 721 (N.D. Cal. 1959).

8. *E.g.*, Childs v. Pegelow, 321 F.2d 487 (4th Cir. 1963); Roberts v. Pegelow, 313 F.2d 548 (4th Cir. 1963); Stroud v. Swope, 187 F.2d 850 (9th Cir. 1951).

9. At the federal level this policy was espoused in Walker v. Blackwell, 360 F.2d 66 (5th Cir. 1966); Haynes v. Harris, 344 F.2d 463 (8th Cir. 1965); Dayton v. Hunter, 176 F.2d 108 (10th Cir. 1949); Platek v. Aderhold, 73 F.2d 173 (5th Cir. 1934). At the state level, the policy was espoused in Weyhrauch v. Parker, 268 F. Supp. 785 (M.D. Pa. 1967); Siegel v. Ragan, 180 F.2d 785 (7th Cir. 1950); Kelly v. Dowd, 140 F.2d 81 (7th Cir. 1944).

10. *See* Note, *Beyond the Ken of the Courts: A Critique of Judicial Refusal to Review the Complaints of Convicts*, 72 YALE L.J. 506 (1963). Besides the administrative and disciplinary policies, other reasons exist for the courts' passivity. For example, at the federal level statutory limitations restrict the courts in their judicial reviewing process. *See* 18 U.S.C. § 4001 (1964). Further, federal courts have noted that certain rights are incident to state citizenship and therefore are enforceable only by state courts. *E.g.*, United States *ex rel.* Atterbury v. Ragen, 237 F.2d 953 (7th Cir. 1956). Also it has been noted that a proper balance should be struck between state and federal law enforcement. Wright v. McMann, 257 F. Supp. 739 (N.D.N.Y. 1966). *See also* Screws v. U.S., 325 U.S. 91, 108 (1945).

11. *See* Negrich v. Hohn, 246 F. Supp. 173 (W.D. Pa. 1965). In Beckett v. Kearney, 247 F. Supp. 219, 220 (N.D. Ga. 1965), the court stated the problem: "There is, therefore, in between the constitutional rights of a prisoner on the one hand and the disciplinary rights of the authorities on the other hand, a vast no-man's land."

12. *E.g.*, Cooper v. Pate, 378 U.S. 546 (1964) (religious beliefs cannot be basis for denying prisoner right to purchase certain religious publications and for denying him privileges granted to other prisoners); Pierce v. La Vallee, 293 F.2d 233 (2d Cir. 1961) (religious beliefs cannot be basis for placing prisoner in solitary confinement and depriving him of good time credit); Fulwood v. Clemmer, 206 F. Supp. 370 (D.D.C. 1962) (prisoner has absolute right to religious belief of his choice).

wrongs,[13] essential medical treatment,[14] and equality of treatment without regard to race.[15] However, in order to determine whether a prisoner had other judicially protected rights, federal courts have applied various standards, indicating that before an inmate's claim could be justiciable the alleged violation of the prisoner's right had to be: shocking to the "general conscience and intolerable to fundamental fairness,"[16] "extreme,"[17] "rare and exceptional,"[18] or "conducive to irreparable injury."[19] Other standards have been used by the federal judiciary to determine the justiciability of prisoners' claims.[20] In balance, however, federal courts continued to show substantial reluctance to exercise judicial review of the merits of prisoner complaints.[21]

In the instant case the court recognized that, although the traditional view was that federal courts had no power to regulate the

---

13. *E.g.,* Dowd v. United States, 340 U.S. 206 (1951); *Ex parte* Hull, 312 U.S. 546 (1941); Haines v. Castle, 226 F.2d 591, 593 (7th Cir. 1955). In Smartt v. Avery, 370 F.2d 788 (6th Cir. 1967), the court struck down a prison regulation which permitted a one year delay in parole consideration for inmates who sought relief through a writ of habeas corpus and were denied. Of course, a habeas corpus petition only tests the legality of detention and not the legality of treatment when confined. *See also* Escoe v. Zerbst, 295 U.S. 490 (1935). For an early history of *in forma pauperis* proceedings to obtain redress in federal courts, see Brinkley v. Louisville & N. R. R., 95 F. 345 (W.D. Tenn. 1899).

14. *E.g.,* Edwards v. Duncan, 355 F.2d 993 (4th Cir. 1966); United States v. Ragen, 337 F.2d 425 (7th Cir. 1964); McCollum v. Mayfield, 130 F. Supp. 112 (N.D. Cal. 1955); Gordon v. Garrson, 77 F. Supp. 477 (E.D. Ill. 1948).

15. In Washington v. Lee, 390 U.S. 333 (1968), tbe Court noted that "prison authorities have the right, acting in good faith and in particularized circumstances, to take into account racial tensions in maintaining seeurity, discipline and good order in prison." But the Court there stated unequivocally that this in no way diluted its firm commitment to the fourteenth amendment's prohibition of racial discrimination. *Contra,* Nichols v. McGee, 169 F. Supp. 721 (N.D. Cal. 1959).

16. *E.g.,* Childs v. Pegelow, 321 F.2d 487, 489 (4th Cir. 1963), *cert. denied,* 376 U.S. 932 (1964), holding that federal prison officials were not required to meet the demands of Muslim inmates for special dining hours. *See also* Tabor v. Hardwick, 224 F.2d 526, 529 (5th Cir. 1955).

17. Lee v. Tahash, 352 F.2d 970 (8th Cir. 1965) (one letter per day correspondence limit held reasonable).

18. *E.g.,* Carey v. Settle, 351 F.2d 483, 485 (8th Cir. 1965), upholding a regulation limiting each prisoner to possession of 5 books in his cell.

19. *E.g.,* People v. Bibb, 252 F.2d 217 (7th Cir. 1958); Kelly v. Dowd, 140 F.2d 81 (7th Cir. 1944).

20. *E.g.,* Jackson v. Godwin, 400 F.2d 529 (5th Cir. 1968); United States *ex rel.* Marcial v. Fay, 247 F.2d 662 (2d Cir. 1957); Jackson v. Bishop, 268 F. Supp. 804 (E.D. Ark. 1967); United States *ex rel.* Cleggett v. Pate, 229 F. Supp. 818 (N.D. Ill. 1964).

21. *See, e.g.,* Tilden v. Pate, 390 F.2d 614 (7th Cir. 1968); Negrich v. Hohn, 379 F.2d 213 (3rd Cir. 1967); Childs v. Pegelow, 321 F.2d 487 (4th Cir. 1963); Wright v. McMann, 257 F. Supp. 739 (N.D.N.Y. 1966).

internal discipline of state prisons, in certain instances courts have allowed redress under section 1 of the Civil Rights Act to prisoners whose federally protected rights were violated, particularly the right to equal protection of the laws. The court noted that the state penal system had adopted a rule which had the effect of punishing the prisoner by postponing his parole. It further reasoned that the facts relied on to substantiate the violation by a prisoner could not be capriciously or unreliably determined, because such a determination would violate the due process and equal protection clauses of the fourteenth amendment. The court found that since the prison warden, in denying parole consideration to plaintiff, relied on information ascertained capriciously by prison guards, the penal administration had violated plaintiff's right to equal protection under the law. Therefore, the court ruled that plaintiff's complaint was justiciable.[22]

The instant decision does not represent an unequivocal commitment on the part of the federal judiciary to scrutinize more closely the activities of state penal systems, but it is a step in the right direction. As the court noted, federal courts have traditionally refrained from interfering with state prison management, but it is also important to realize that this restraint has existed at the federal prison level also.[23] Since federal courts have heard prisoners' complaints in exceptional cases, this case could be considered as no more than another federal court acting in an exceptional circumstance were it not for the fact that the circumstances of the instant case are rather unexceptional when compared to previous cases of prisoner review. Thus the significance of the instant decision lies in the fact that although the right violated was not extreme and the punishment rendered was not extraordinary, the prisoner's complaint was yet considered justiciable, giving rise to an inference that the federal judiciary may be headed toward a more zealous protection of prisoners' rights.

An examination of the state penal system from several perspectives may illustrate how and why court review can be a substantial factor in protecting inmate rights. State penal systems are part of the political system of any state. Usually the high appointive positions in state penal systems are given to individuals who have

---

22. *See* note 2 *supra*.
23. *See* notes 9 & 10 *supra*.

aided the election of state officials.[24] It is probable, therefore, that one who holds a high penal position is more competent in politics than in penal administration. The same observation may be applied to those in immediate contact with the inmates themselves, the prison guards. They are more interested in maintaining the status quo in the prison than in its rehabilitative aspects. As long as the prison functions without major disruption, no one in the political machinery is disturbed; and because the general public is almost completely cut off from the reality of prison life, it takes notice of a penal system only when disruption does occur. Thus, the only alternative channel for redress of prison injustice is through the courts.

However, before prisoner complaints can be successful in courts, the complaints must be legally accurate and intelligible; otherwise, a valid complaint may be rejected on grounds of failure to state a justiciable claim. In most prisons the inmates have limited access to legal material; thus it is extremely difficult for them to ascertain whether they have a valid legal claim against the administration if they believe a right has been violated. If prisoners do not know the law, they cannot be expected to know when their rights have been violated; even with a superficial understanding of the law, it cannot be expected that they will file a complaint conforming to the pleading requirements of federal courts.[25] For these reasons courts should be hesitant to discourage complaints and quick to construe ambiguous complaints favorably when it is evident that a miscarriage of justice would result from a strict, technical interpretation of the complaint.[26]

On the other hand, it is argued that prison officials need broad discretion in managing the internal affairs of the prison, and it would thus seem anomalous that the prisoner should have the right to demand treatment by law equal to that received by those not

---

24. *See* J. HAGERTY, TWENTIETH CENTURY CRIME; EIGHTEENTH CENTURY METHODS OF CONTROL 129 (1934).

25. *See* Johnson v. Avery, 89 S. Ct. 747 (1969), where the Court noted that it is fundamental that prisoners may not be denied access to the courts for the purpose of pressing complaints. The Court held that prisoners in a state penal institution have a federally protected right to the assistance of fellow inmates in preparing and filing habeas corpus petitions if no other effective assistance is available.

26. The instant case is an excellent example of a liberal approach to pleading requirements. The possibility of a poorly framed complaint would be greatly minimized if prisoners were allowed effective advice when writing complaints. Legal aid organizations should be permitted to assist prisoners. Such a program would have advantages for the judicial and prison administrations, since the prisoners could be advised at the outset as to the merit of their complaints, thus alleviating the need for courts to stretch the bounds of liberal construction or to become inundated witb frivolous complaints.

incarcerated. It is conceded that in certain instances he does not have a right to demand such treatment. But these instances should be the exception and not the rule. One serving a sentence in theoretical payment of his debt to society should suffer no deprivations in excess of those inherent in the sentence and in the normal structure of prison life, and excesses should be subject to judicial review.[27] Just as the theory of retained legal rights which are enforceable by judicial review is not absolute, it would seem unreasonable to accept absolutely the other extreme, the "hands-off" doctrine. Implicit in the "hands-off" theory is the exaltation of prison discipline over prison rehabilitation, the net effect of which is to view the prison as fundamentally a punitive institution. Admittedly, the prison partakes of both characteristics; yet, the punitive objective of prisons is sufficiently met by depriving the prisoner of contact with the outside world. This deprivation of social contact need not be supplemented by additional arbitrary and judicially non-reviewable treatment of the prisoners for punitive purposes. If rehabilitation is taken as the key objective of prisons, it is essential that courts seek to limit administrative discretion in revoking prisoners' rights, thus encouraging prisoners' respect for the law. If no such respect is developed, it must be said that the rehabilitative process has failed substantially.[28] A definitive policy is necessary, however, in order to allow courts to preserve the balance between the needs of penal administration and the rights and privileges of the prisoners, while at the same time serving the rehabilitative objectives of a penal system.

It is evident that if prison justice is to become a reality, prisoners must not only be granted access to the courts, but more importantly, the courts must apply a definite, articulated policy consistently to determine the justiciability of prisoner complaints. In other words, a hearing for alleged violations of personal rights should be granted to prisoners except in those instances when prison security demands rigid supervision of prisoner mobility and privileges or when prisoner demands are unreasonable when weighed against the administrative burden which would result from meeting such demands. It is submitted, therefore, that courts should decide the question of justiciability not by applying traditional, ambiguous standards, but instead by utilizing a balancing test. If inmates realized that their

27. *See* Jackson v. Godwin, 400 F.2d 529 (5th Cir. 1968).

28. It must be recognized that rehabilitation cannot be forced on an inmate; the desire to change must originate within the individual. *See* Hodge, *The Rehabilitation Process—A Prisoner's Point of View*, 26 AM. J. OF CORRECTION 12 (1964).

rights and interests were weighed equally with those of the administration, their respect for the law would increase, thereby satisfying one goal of the rehabilitative process. Furthermore, by opening judicial review to those complainant's rights,[29] courts could upgrade the quality of state prison administration. Prison officials would be made aware of a more precise standard with which they must comply when exercising their discretion in curtailing prisoner rights.[30] With penal discretion limited to explicit and realistic judicial guidelines, administrative disregard for prisoners' rights and privileges could be greatly discouraged.[31]

## Labor Law—Collective Bargaining—Employer May Not Enforce Collective Bargaining Agreement Provision Embodying Union Waiver of Employee's Right to Solicit Against That Union

Willard Ray Dobbins, an employee of Mid-States Metal Products, Inc., filed a complaint with the NLRB against both Mid-States and its contracting labor organization, International Chemical Workers Union, AFL-CIO,[1] charging that at the union's insistence he

29. Mr. Justice Rutledge noted in his dissent in Sunal v. Large, 332 U.S. 174, 189 (1947), that economy of judicial time and procedures becomes comparatively insignificant when weighed against the necessity for the preservation of personal liberty.

30. For instance, when a federal judge considers a writ of habeas corpus he has the procedural alternative of denying the writ or issuing to the warden an order to show cause why the writ should not be granted. The same procedure could he suitably employed by the federal courts in regard to complaints filed by prisoners under § 1 of the Civil Rights Act. After the court made the initial determination that the claim was prima facie justiciable, it could then issue the order to compel the warden to show cause why redress should not be given to the prisoner. Thus the burden of proof would shift to the warden to show that either prison security or administrative feasibility necessitated the administrative action. *See* Note, *The Burden of Federal Habeas Corpus Petitions from State Prisoners*, 52 VA. L. REV. 486 (1966).

Thus if the prisoner presented a prima facie reviewable complaint, shifting the burden to prison officials to show justification for their acts, there would be a greater tendency for officials to preserve physical evidence supporting their defense that official discretion was not abused. For example, in the instant case, since the plaintiff did not reach the federal courts until 6 years after the alleged contraband incident, it can hardly be expected that the critical evidence, the powder, still existed.

31. There is a further problem of enforcing injunctive relief against prison officials once obtained. As long as the prisoners are held incommunicado or denied legal assistance, there is no positive way to insure compliance with court orders.

1. Local 738, Greenville, Mississippi.

had been wrongfully discharged by Mid-States for engaging in anti-union activity. Dobbins alleged that the collective bargaining agreement provision which purported to prohibit such activity was illegal.[2] The NLRB found that the union had violated the National Labor Relations Act by threatening Dobbins with physical violence and discharge for his activities in attempting to de-certify the union as the employees' collective bargaining agent through circulation of a petition for decertification. The Board found that the union committed an unfair labor practice when it caused the employer to discharge Dobbins for engaging in activities prohibited by the collective bargaining agreement.[3] The Board also found that the employer's enforcement of the no-solicitation provision constituted an unfair labor practice[4] abridging employee rights guaranteed by section 7 of the Act.[5] Relying upon these findings, the Board issued a cease and desist order against Mid-States and the union.[6] On petition to the Court of Appeals for the Fifth Circuit by the NLRB for enforcement of its order, *held*, order enforced. An incumbent labor organization may not waive employee rights to solicit against it during non-working hours on company premises, and such waiver may not be enforced as part of a collective bargaining agreement by the employer since enforcement of such a waiver violates the fundamental section 7 right of employees to select a collective bargaining representative of their own choosing. *NLRB v. Mid-States Metal Products, Inc.*, 403 F.2d 702 (5th Cir. 1968).

Cases involving the validity of collective bargaining agreement

---

2. The provision purported to prohibit unauthorized soliciting, collection of contributions and distribution of literature or printed matter for any purpose whatsoever on company premises.

3. The union was found guilty of violations of National Labor Relations Act (Wagner Act) §§ 8(b)(1)(A) & 8(b)(2), 29 U.S.C. §§ 158(b)(1)(A) & 158(b)(2) (1964).

4. Mid-States was found guilty of violating National Labor Relations Act (Wagner Act) §§ 8(a)(1), (2) & (3), 29 U.S.C. § 158(a)(1), (2) & (3) (1964). Mid-States contended that it had discharged Dobbins for possession of a weapon on company premises rather than for his anti-union activity. Dobbins did have a shotgun in his car during the time immediately preceding his discharge, but this he claimed was a precaution made necessary by threats of mob violence from the union. The NLRB concluded that the possession of the weapon was not the real reason for Dobbins' discharge.

5. National Labor Relations Act (Wagner Act) § 7, 29 U.S.C. § 157 (1964), provides in pertinent part as follows: "Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in *other* concerted activities for the purpose of collective bargaining or other mutual aid or protection, *and shall also have the right to refrain from any or all such activities.*" (emphasis in original).

6. Mid-States Metal Products, Inc., 156 N.L.R.B. 872 (1966).

provisions containing a union waiver of employee solicitation rights have been before the courts of appeals on three occasions. In *NLRB v. Gale Products*,[7] the Seventh Circuit refused enforcement of the Board's cease and desist order under factual circumstances very similar to the instant case. The *Gale* court relied in part upon an NLRB case which the Board itself had since ceased to follow.[8] On the authority of *Gale*, the Sixth Circuit decided two cases in which it also refused to enforce the Board's invalidation of such waiver provisions.[9] Although minor factual differences distinguish these cases from the instant case,[10] the Sixth and Seventh Circuits reached the opposite conclusion, that "[t]he contract provisions here assailed did not strip the employees of *fundamental* rights guaranteed by the Act."[11] On the other hand, courts have upheld the right of the employer to promulgate and enforce rules against solicitation on company premises during non-work time under circumstances where some limitation on the right to solicit is necessary for the maintenance of production or discipline.[12] The determinative factor in these cases was the necessity of the restriction imposed rather than the validity of waiver or enforcement. Further, a number of cases directly involving union waiver of employee rights have arisen in which the courts have approved such waiver[13] when necessary to effectuate the congressional

---

7. 337 F.2d 390 (7th Cir. 1964), *denying enforcement of* 142 N.L.R.B. 1246 (1963).

8. May Dep't Stores Co., 59 N.L.R.B. 976 (1944); *accord*, Clinton Foods, Inc., 112 N.L.R.B. 239 (1955); Fruitvale Canning Co., 90 N.L.R.B. 884 (1950); *cf.* North Am. Aviation, Inc., 56 N.L.R.B. 959 (1944).

9. General Motors Corp. v. NLRB, 345 F.2d 516 (6th Cir. 1965), *denying enforcement of* 147 N.L.R.B. 509 (1964); Armco Steel Corp. v. NLRB, 344 F.2d 621 (6th Cir. 1965), *denying enforcement of* 148 N.L.R.B. 1179 (1964). *See also* Getreu v. Armco Steel Corp., 241 F. Supp. 376 (S.D. Ohio 1964).

10. The major factual difference was that the no-solicitation provisions were enforced uniformly by the employers against all employees in *Gale*, *Armco* and *General Motors*, whereas in the instant case the company's position was that it could enforce or not enforce as it chose. The *Gale* court also considered relevant an offer by the company to provide an alternative means for employee communication among themselves respecting labor organizations. Additionally, the instant case arose in a right-to-work jurisdiction, Mississippi, while *Gale* and *Armco* did not. MISS. CODE ANN. § 6984.5 (Supp. 1966). The instant court, however, stated specifically that it did not consider this distinction determinative. 403 F.2d at 706 n.8. *See* 1967 U. ILL. L.F. 174.

11. NLRB v. Gale Products, 337 F.2d 390, 392 (7th Cir. 1964) (emphasis added).

12. *E.g.*, Republic Aviation Corp. v. NLRB, 324 U.S. 793 (1945); NLRB v. LeTourneau Co., 324 U.S. 793 (1945) (decided with *Republic*); Brewton Fashions, Inc. v. NLRB, 361 F.2d 8 (5th Cir.), *cert. denied*, 385 U.S. 842 (1966); NLRB v. Southwire Co., 352 F.2d 346 (5th Cir. 1965); NLRB v. Walton Mfg. Co., 289 F.2d 177 (5th Cir. 1961); *cf.* Republic Alum. Co. v. NLRB, 394 F.2d 405 (5th Cir. 1968).

13. NLRB v. General Motors Corp., 373 U.S. 734 (1963) (agency shop); Teamsters Local

policy of encouraging collective bargaining.[14] The rationale underlying these decisions is that the collective bargaining agent must be given a wide range of flexibility in serving the bargaining unit, making concessions and accepting advantages in light of relevant considerations it believes to be in the best interest of the employees it represents.[15]

In the instant case, the court noted initially that the NLRA was enacted primarily for the benefit of *employees* rather than for the benefit of labor organizations and that the prohibition against unfair labor practices by employers was intended as a grant of rights to employees, not of powers to unions.[16] Consequently, union waiver of these rights should be ineffective except where necessary to further the policies of the Act[17] and where the union's interests are identical to those of the employees.[18] Turning to an analysis of the right to solicit purportedly waived by the International Chemical Workers Union,[19] the majority reasoned that since the interests of the employee and the incumbent union in regard to the identity of the collective bargaining agent might be wholly adverse, the union could have no reason in such circumstances for preventing solicitation against itself except as a means of self-preservation.[20] Thus, the court determined that the right

---

No. 357 v. NLRB, 365 U.S. 667 (1961) (hiring hall); NLRB v. News Syndicate Co., 365 U.S. 695 (1961) (hiring by union foremen); United Steelworkers v. Warrior & Gulf Nav. Co., 363 U.S. 574 (1960) (no strike or lockout); NLRB v. Wooster Div. of Borg Warner Corp., 356 U.S. 342 (1958) (ballot and recognition); Radio Officers' Union v. NLRB, 347 U.S. 17 (1954) (union security); Ford Motor Co. v. Huffman, 345 U.S. 330 (1953) (seniority credit for military service); NLRB v. American Nat'l Ins. Co., 343 U.S. 395 (1952) (management functions). *See*, NLRB v. Lundy Mfg. Corp., 316 F.2d 921 (2d Cir. 1963). *Compare* NLRB v. Bell Aircraft Corp., 206 F.2d 235 (2d Cir. 1953).

14. "It is hereby declared to be the policy of the United States to eliminate the causes of certain substantial obstructions to the free flow of commerce . . . by encouraging the practice and procedure of collective bargaining." National Labor Relations Act (Wagner Act) § 1, 29 U.S.C. § 151 (1964).

15. *See* Ford Motor Co. v. Huffman, 345 U.S. 330 (1953); NLRB v. Lundy Mfg. Corp., 316 F.2d 921 (2d Cir. 1963).

16. *See* NLRB v. Red Arrow Freight Lines, Inc., 193 F.2d 979 (5th Cir. 1952); NLRB v. Augusta Chem. Co., 187 F.2d 63 (5th Cir. 1951); NLRB v. Schwartz, 146 F.2d 773 (5th Cir. 1945).

17. *See* note 14 *supra*.

18. *See* cases cited note 13 *supra*.

19. This right stems from the collective bargaining and organizational rights granted by National Labor Relations Act (Wagner Act) § 7, 29 U.S.C. § 157 (1964).

20. Hughes Tool Co. v. NLRB, 147 F.2d 69, 75 (5th Cir. 1945): "A union chosen for a time to be bargaining representative of a unit which includes members of other unions has no right to use its position to destroy the other unions. It must . . . secure itself in its office of representative only by the skill, efficiency, and fairness with which it executes that office."

to choose a collective bargaining agent includes the right to oust that agent if and when the employees believe that another union might better serve as their bargaining representative. Accordingly, the court reasoned that enforcement of the no-solicitation provision by Mid-States was essentially a method of favoring the incumbent union over rivals, an activity consistently condemned by the courts as an unfair labor practice.[21] Noting that employer neutrality is required where employees exercise their fundamental right to choose a collective bargaining representative,[22] the court concluded that this right is so fundamental that it should not be subject to waiver by unions nor subject to prohibition by employers through agreements restricting employee solicitation against the existing labor organization.

In terms of immediate effect, the instant decision has cast new doubt on the validity of contracts embodying no-solicitation provisions and has created a conflict among the circuits. Of the four cases on the issue, the instant case is the first to adopt the Board's policy against enforced prohibition of employee solicitation. However, it is submitted that the court's reasoning is particularly persuasive despite its minority status, since it is based upon premises which were not considered controlling in the three cases decided contra. Fundamental to the instant decision is the determination that an employer ought to remain neutral when employees exercise their right to choose or reject a collective bargaining agent.[23] Such neutrality cannot be maintained when the employer enforces an agreement prohibiting solicitation against the incumbent union. To hold otherwise would be to legitimize union self-perpetuation with the force and authority of an enforceable collective bargaining agreement without regard to the wishes of the employee. The court foresaw the possible abuses that might flow from approval of a practice that could have little justification other than union self-interest: with its own existence guaranteed, the union might have less interest in doing its best for those whom it represents. The court recognized that such a situation would impair seriously the employee's right to choose his bargaining representative freely as well as his right to have the best

---

21. *E.g.*, NLRB v. Waterman S.S. Co., 309 U.S. 206 (1940); Majestic Molded Prods., Inc. v. NLRB, 330 F.2d 603 (2d Cir. 1964); NLRB v. Yale & Towne Mfg. Co., 114 F.2d 376 (2d Cir. 1940).

22. *See generally* International Ass'n of Machs. v. NLRB, 311 U.S. 72 (1940); NLRB v. Park Edge Sheridan Meats, Inc., 323 F.2d 956 (2d Cir. 1963); NLRB v. Gluek Brewing Co., 144 F.2d 847 (8th Cir. 1944); NLRB v. John Englehorn & Sons, 134 F.2d 553 (3d Cir. 1943).

23. *See* cases cited note 22 *supra*.

representation which the agent can furnish. As a result, the court accepted the NLRB's position against enforcing no-solicitation provisions by requiring employer neutrality as the best means to assure that employees' section 7 rights are not violated. This requirement should, of course, help remove the employer from the hands of the incumbent union as an effective instrument of self-preservation. But despite the importance of that ruling alone, the court's holding that a union may not waive employees' section 7 rights has broad implications beyond the collective bargaining process itself. If the incumbent union cannot waive employees' section 7 rights, then surely it cannot interfere with those same rights by other means. Presumably, the union may not resort to overt coercion nor subtle discrimination in order to gain or retain unfair advantage over rival organizations. The instant opinion carries strong indications that such conduct will be disapproved. At any rate, the court's adoption of Board policy and the persuasive rationale which it gives justifying that policy should provide convincing precedent for future protection of employee rights in the selection of collective bargaining representatives.[24]

## Labor Law—Remedies—NLRB May Order Retroactive Payment of Fringe Benefits Where Employer Wrongfully Refuses to Sign Collective Bargaining Agreement

Respondent roofing company was a member of a multi-employer bargaining association which had negotiated a collective bargaining contract with the Roofers Union[1] establishing four-year compensation levels for the employees of member firms. Respondent sought to withdraw from the association subsequent to the effective date of the contract and refused the repeated demands of the union that it sign the agreement.[2] Pursuant to unfair labor practice charges filed by the union,[3] the NLRB found that respondent's refusal to sign the contract

24. *See generally* Gould, *The Question of Union Activity on Company Property*, 18 VAND. L. REV. 73 (1964); 1967 U. ILL. L.F. 174.

1. Roofers Local 36, United Slate, Tile and Composition Roofers, Damp and Waterproof Workers Association.

2. The contract was to become effective on August 15, 1963. Respondent sought to withdraw from the association five days later on August 20, 1963. 393 U.S. at 358.

3. Respondent did not dispute the fact that it withdrew its membership too late to escape

negotiated on its behalf by the association violated sections 8(a)(1) and 8(a)(5) of the National Labor Relations Act (NLRA).[4] The Board ordered respondent to sign the contract and to pay to the appropriate source any fringe benefits provided for in the contract.[5] The Court of Appeals for the Ninth Circuit refused to enforce that part of the Board's order requiring the retroactive payment of fringe benefits on the ground that it was beyond the power of the Board to order respondent to carry out provisions of the collective bargaining agreement.[6] On certiorari to the Supreme Court of the United States, *held*, reversed. Section 10(c) of the NLRA empowers the NLRB to require the retroactive payment of fringe benefits which would have been paid to employees had the employer not wrongfully refused to sign and acknowledge the contract which had been duly negotiated on its behalf. *NLRB v. Strong*, 393 U.S. 357 (1969).

Section 10(c) of the NLRA authorizes the NLRB, where it finds that any person named in a complaint has engaged in an unfair labor practice, "to take affirmative action including reinstatement of employees with or without back pay, as will effectuate the policies of this Act . . . ."[7] In *Phelps Dodge Corporation v. NLRB*,[8] the Supreme Court interpreted the remedial power of section 10(c) and held that the public policy of the Act demands that workers be made whole for losses suffered on account of unfair labor practices.[9] The Court reasoned that Congress had left to the administrative competence of the Board the choice of remedies in effectuating this policy.[10] The Board's power to take affirmative action is, however,

the binding force of the agreement negotiated on its behalf. Nor, in light of H.J. Heinz Co. v. NLRB, 311 U.S. 514, 524-26 (1941), was there any doubt that respondent's failure to sign the contract was an unfair labor practice which could be remedied by an order requiring that the contract be reduced to writing. The sole issue raised by this case is the power of the Board under § 10(c) of the Wagner Act to order an employer to grant retroactive effect to the terms of the agreement which it refused to acknowledge in writing.

4. National Labor Relations Act (Wagner Act) § 8(a), 29 U.S.C. § 158(a) (1964): "It shall be an unfair labor practice for an employer—(1) to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7 . . . (5) to refuse to bargain collectively with the representatives of his employees, subject to the provisions of section 9(a) . . . ."

5. Joseph T. Strong, 152 N.L.R.B. 9, 14 (1965).

6. NLRB v. Strong, 386 F.2d 929, 933 (9th Cir. 1967).

7. National Labor Relations Act (Wagner Act) § 10(c), 29 U.S.C. § 160(c) (1964).

8. 313 U.S. 177 (1941).

9. *Id.* at 197.

10. *Id.* at 194: "Congress met these difficulties by leaving the adaptation of means to end to the empiric process of administration. The exercise of the process was committed to the Board, subject to limited judicial review. Because the relation of remedy to policy is peculiarly a

subject to two court-created limitations under section 10(c): (1) the sanction must be remedial rather than punitive;[11] and (2) the remedy must be appropriate to the particular situation confronting the Board.[12] In general, the Board's authority does not empower it to adjudicate or administer collective bargaining contracts.[13] Congress has left enforcement of such agreements to the parties themselves, through grievance and arbitration procedures, and to the courts, pursuant to section 301(a) of the Labor Management Relations Act.[14] However, in section 10(a) of the NLRA Congress specified that the power of the Board to remedy an unfair labor practice "shall not be affected by any other means of adjustment or prevention that has been or may be established by agreement, law or otherwise . . . ."[15] Thus the Board may proscribe conduct which is an unfair labor practice even though the same conduct may be subject to arbitration as a breach of a collective bargaining agreement,[16] and if necessary, the Board may interpret the terms of the contract to determine whether a party has engaged in an unfair labor practice.[17] Section 8(d) of the NLRA,[18] added by the Taft-Hartley Amendments, makes clear that a refusal to execute a written contract incorporating an

---

matter for administrative competence, courts must not enter the allowable area of the Board's discretion and must guard against the danger of sliding unconsciously from the narrow confines of law into the more spacious domain of policy."

11. Republic Steel Corp. v. NLRB, 311 U.S. 7 (1940); Consolidated Edison Co. v. NLRB, 305 U.S. 197 (1938).

12. NLRB v. Seven-Up Bottling Co., 344 U.S. 344 (1953); NLRB v. Bradford Dyeing Ass'n, 310 U.S. 318, 342 (1940).

13. *See* NLRB v. Hyde, 339 F.2d 568, 572 (9th Cir. 1964); United Steelworkers v. American Int'l Aluminum Corp., 334 F.2d 147, 152 (5th Cir. 1964).

14. Labor Management Relations Act (Taft-Hartley Act) § 301(a), 29 U.S.C. § 185(a) (1964): "Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this Act, or between any such labor organizations, may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties." *See* Textile Workers v. Lincoln Mills, 353 U.S. 448 (1957).

15. National Labor Relations Act (Wagner Act) § 10(a), 29 U.S.C. § 160(a) (1964).

16. Smith v. Evening News Ass'n, 371 U.S. 195, 197-98 (1962): "The authority of the Board to deal with an unfair labor practice which also violates a collective bargaining contract is not displaced by § 301, but it is not exclusive and does not destroy the jurisdiction of the courts in suits under § 301. If, as respondent strongly urges, there are situations in which serious problems will arise from both the courts and the Board having jurisdiction over acts which amount to an unfair labor practice, we shall face those cases when they arise."

17. NLRB v. C & C Plywood Corp., 385 U.S. 421, 428 (1967). "Thus, the Board, in necessarily construing a labor agreement to decide this unfair labor case, has not exceeded the jurisdiction laid out for it by Congress."

18. National Labor Relations Act (Wagner Act) § 8(d), 158(d): "For the purposes of this section, to bargain collectively is . . . the negotiation of an agreement, or any question arising

agreement reached between the parties is a refusal to bargain in good faith in violation of section 8(a)(5).[19] In *H.J. Heinz Co. v. NLRB*,[20] the Supreme Court recognized that a refusal to acknowledge the agreement in writing constituted an unfair labor practice under section 8(a)(5) and upheld an order directing the employer to sign any agreement reached between the parties.[21] Following the rule in the *Heinz* case, the NLRB has on several occasions ordered an employer to give retroactive effect to the terms of a labor contract where the Board has determined that there was a wrongful refusal to reduce the agreement to writing.[22] Prior to the instant decision, however, the Supreme Court has never ruled on the appropriateness of utilizing this remedy under the powers authorized in section 10(c) of the Act.

In the instant case the Court found that the Board's order requiring the respondent to pay fringe benefits reserved in the contract was well within its section 10(c) powers. The Court initially reviewed its earlier decisions allowing the Board to remedy an unfair labor practice where the challenged conduct also constituted a breach of contract remediable by arbitration. Noting that section 8(d) allows the Board to inquire whether negotiations have produeed an agreement which the employer refuses to sign, the Court reasoned that the collective bargaining contract is to this extent within the scope of the Board's inquiry, just as determination of an effective remedy for refusal to sign is well within its section 10(c) authorization. The Court compared the order in the instant case to the reinstatement of an employee with back pay when wrongfully dismissed, as for union membership. Although such conduct may be a breach of contract open to arbitration, it is also an unfair labor practice which may be remedied under section 10(c). The majority reasoned that the Board's

---

thereunder, and the execution of a written contract incorporating any agreement reached if requested by either party, but such obligation does not compel either party to agree to a proposal or require the making of a concession . . . ."

19. National Labor Relations Act (Wagner Act) § 8(a)(5), 29 U.S.C. § 158(a)(5) (1964): "It shall be an unfair labor practice for an employer—. . . (5) to refuse to bargain collectively with the representatives of his employees, subject to the provisions of section 9(a) . . . ."

20. 311 U.S. 514 (1941).

21. *Id.* at 526: "The freedom of the employer to refuse to make an agreement relates to its terms in matters of substance and not, once it is reached, to its expression in a signed contract, the absence of which, as experience has shown, tends to frustrate the end sought by the requirement for collective bargaining."

22. *E.g.*, Schill Steel Prods., Inc., 161 N.L.R.B. 939 (1966); Tulsa Sheet Metal Works, Inc., 149 N.L.R.B. 1487 (1964), *enforced*, 367 F.2d 55 (10th Cir. 1966); Ogle Protection Serv., Inc., 149 N.L.R.B. 545 (1964), *enforced*, 375 F.2d 497 (6th Cir.), *cert. denied*, 389 U.S. 843 (1967).

order required only the payment of those benefits reserved in the contract that would have been paid had the employer not engaged in an unfair labor practice and as such the order was no more than the Act and cases like *Phelps Dodge* plainly authorize. Mr. Justice Douglas, in a dissenting opinion, argued that section 301 of the Labor Management Relations Act expressed the congressional intent to leave the enforcement of labor contracts to the parties themselves. He stressed the policy of engaging the process of arbitration with the aid of trained arbiters possessing special qualifications in a particular industry and familiar with the common law of the shop.[23]

The Court's decision assures the continued effectiveness of section 8(d) of the NLRA.[24] That section was enacted by Congress to prevent employers from frustrating union bargaining efforts by refusing to reduce to written form the terms of the agreement which had been reached. After the Supreme Court in *Heinz* approved the Board's requirement that employers sign contracts which have been agreed upon, the Board further sought to discourage such refusals by granting retroactive effect to the terms of the contract from the date of agreement.[25] The instant case is significant in authorizing the Board to continue this practice, thus making clear to employers that a delayed signing will not be allowed to frustrate the purposes of the collective bargaining provisions in the NLRA. In *Phelps Dodge* the Court interpreted section 10(c) as including the authority to fashion appropriate remedies to make workers whole for losses suffered on account of an unfair labor practice. The instant Court's decision, in requiring the employer to make retroactive payments of fringe benefits where he has committed an unfair labor practice by refusing to sign a properly negotiated agreement, finds a new application for this rule without extending the principle behind it. If section 10(c) did not empower the Board to remedy such a *past* wrong done by an unfair labor practice, the purpose of the statute could be completely avoided by simply committing the unfair labor practice. The effectiveness of section 8(d) is ultimately dependent upon the ability of the Board to make a refusal to execute the agreement a pointless act. In *Phelps*

---

23. "What the 'common law' of the shop would show covering these fringe benefits, what 'past practices' might reflect on the amount of an award, what 'a fair solution' of the problem might seem to be in an arbitration frame of reference, no one knows. These are matters for arbiters, chosen by the parties under the collective agreement, not for the Board, an alien to the system envisioned by *Lincoln Mills*." 393 U.S. at 366.

24. National Labor Relations Act (Wagner Act) § 8(d), 29 U.S.C. § 158(d) (1964).

25. *See* cases cited note 22 *supra*.

*Dodge* the Court recognized that Congress intended for the Board to possess this ability.[26] The dissent of Mr. Justice Douglas is without support in law or in logic. In addition to his failure to recognize the many cases distinguishing a mere contractual dispute from an unfair labor practice case, he fails to deal with the question of why the guilty employer should be allowed to require the union to submit to an arbitration agreement which the employer has wrongfully refused to acknowledge in writing as required by section 8(d) of the Act.[27] The majority opinion is clearly correct and contributes a long-awaited precedent for those who seek to effectuate the fundamental policy of the Act—productive bargaining between labor and management.

## Religious Societies—First Amendment Prohihits Civil Courts From Determining Doctrinal Questions iu Resolving Church Property Disputes

A dispute arose between petitioner, Presbyterian Church in the United States, and two local churches in Savannah, Georgia, over control of church properties used by the local churches. In response to various pronouncements and actions related to civil, economic, social and political matters,[1] the local churches resolved that the general church had departed from the faith and practice existing at the time they affiliated with it[2] and announced that henceforth they would function autonomously. Claiming that the properties were held under an implied trust for the use and benefit of those members adhering to the doctrines and regulations of the general church, the petitioner

26. 313 U.S. at 194.
27. *See* 393 U.S. at 362.

1. The petitioners alleged that the general church had, among other things, ordained women as ministers and elders, given its support to the removal of Bible readings from public schools, and caused its members to remain in and accepted the leadership of the National Council of Churches of Christ, which advocated the decline of parental authority, the practice of civil disobedience and unwarranted intermeddling in civil affairs. The General Assembly's adoption of a policy statement suggesting cessation of all bombing of North Vietnam as a means to bring about unconditional negotiation and the endorsement of the civil rights movement were among the activities cited as improper involvement in civil affairs.

2. The enumerated bases of faith and practice of the general church when formed in 1861 were: the Old and New Testaments of the Holy Bible, the Westminster Confession of Faith, and the Larger and Shorter Catechisms. In particular, the local churches alleged the general church had violated the provision in the Westminster Confession of Faith that states: "synods and councils are to handle or conclude nothing but that which is ecclesiastical: and are not to

undertook, by resolution of an Administrative Commission of the Presbytery of Savannah, to fill offices that had been vacated at the time the local churches withdrew from the general organization and to provide ministerial leadership and regular services in the sanctuaries of the local churches. Thereafter, injunctive relief was sought by the local churches to prevent petitioner from interfering with their exclusive use and control of the local properties. Petitioner contended that the resolution of the Administrative Commission was in accordance with the constitution and laws of the general church, that under its presbyterian government, representative in form,[3] the local churches were subject to these provisions, and that when they failed to appeal the decision it became final and binding on the parties and the court. The trial court granted the local churches permanent injunctions against acts of trespass by the general church. The Georgia Supreme Court affirmed,[4] concluding that the general church had substantially abandoned the tenets of faith and practice existing at the time of affiliation, thus entitling the local churches to the use and possession of local church properties. On writ of certiorari to thc United States Supreme Court, *held*, reversed. The departure-from-doctrine element of the implied trust theory, insofar as it requires an interpretation of church doctrines and the importance of those doctrines to the religion, violates the first amendment command that civil courts decide church property disputes without resolving underlying controversies over religious doctrine and practice. *Presbyterian Church in the United States v. Mary Elizabeth Blue Hull Memorial Presbyterian Church*, 393 U.S. 440 (1969).

In *Watson v. Jones*[5] the Supeme Court held on non-constitutional

---

intermeddle with civil affairs which concern the commonwealth unless by way of humble petition in cases extraordinary; or by way of advice for satisfaction of conscience, if they be thereunto required by the civil magistrate." ch. XXXIII, ¶ 4; "[i]t is the duty of the people to pray for magistrates, to honor their persons, to pay them tribute and other dues, to obey their lawful commands, and to be subject to their authority, for conscience' sake. Infidelity, or difference in religion, doth not make void the magistrate's just and legal authority, nor free the people from their due obedience to him; from which ecclesiastical persons are not exempted . . . ." ch. XXV, ¶4.

3. The governmental hierarchy of the Presbyterian Church in the United States is structured as follows: (1) the Session of each local church; (2) the Presbytery, which is composed of several Sessions in a geographical area; (3) the Synod, which is composed of Presbyteries, usually those within a state; and (4) the General Assembly. This organization also constitutes the judicial system for the church.

4. 224 Ga. 61, 159 So. 2d 690 (1968).

5. 80 U.S. (13 Wall.) 679 (1871).

grounds[6] that decisions of the highest tribunal within a church having a representative form of government are binding upon civil courts where the rights of property[7] are dependent upon questions of church doctrine, ecclesiastical law or church government.[8] An exception to this rule was recognized only in cases where there had been fraud, collusion or arbitrariness, or where property had been devoted by express terms to the use or support of some specific form of religious doctrine. In these situations the Court was not bound by the decision of such tribunals, but was under a duty to determine for itself whether there has been a diversion of the property from its intended use.[9] In absence of an express trust, the narrow scope of the rule in *Watson* restricted the review of a court to a determination of whether the church tribunal in fact represented the supreme authority within the church organization. When this was determined, the decisions of that tribunal were binding on the court. Subsequent decisions suggested that the rule in *Watson* might have constitutional status,[10] though the case itself had not been decided on such a ground.

In contrast to this doctrine of abstention, Lord Eldon, in *Attorney General ex rel. Mander v. Pearson*,[11] committed the English courts to a policy of involvement in the determination of questions of religious doctrine where property rights were in issue. Under the *Pearson* approach, where there are conflicting claims to church property the court will determine any questions concerning church doctrine and award the property to the group the court finds is loyal to the faith and practice existing when the property was acquired.[12]

---

6. *Watson v. Jones* was decided in 1871, before judicial recognition that the fourteenth amendment incorporated first amendment limitations against state action.

7. For treatment of property disputes in independent or congregational churches where the conflict is between factions within a single church, see Annot., 15 A.L.R.3d 297 (1967).

8. *Watson v. Jones* was the result of a conflict that developed within a local presbyterian church in Louisville, Kentucky, over the question of slavery. In 1863, the General Assembly of the Presbyterian Church adopted a resolution that required citizens from southern states to declare their opposition to slavery if they desired to be missionaries or ministers. A small minority in the church opposed the position of the General Assembly, seized the local church property and proceeded to affiliate with the Presbyterian Church of the Confederate States. The basis of the minority claim to the property was that the resolution violated the provision of the church constitution prohibiting the General Assembly from intermeddling in civil affairs.

9. Gonzales v. Roman Catholic Archbishop, 280 U.S. 1, 16 (1929).

10. *E.g.*, Kedroff v. Saint Nicholas Cathedral, 344 U.S. 94, 116 (1952).

11. 36 Eng. Rep. 135 (Ch. 1817).

12. Several years later Lord Eldon acknowledged the difficulty of attempting to solve intricate questions of doctrine: "[T]here may be some doubt whether we understand the subject, not only because the Court of Session was much more likely to understand the matter than we are; but because I have had the mortification, I know not how many times over, to endeavour

While a substantial number of decisions in state courts followed the *Watson* position,[13] a number of decisions demonstrated a preference for the *Pearson* approach.[14] In *Landrith v. Hudgins*,[15] where property rights depended upon the validity of particular acts of a church organization, the court disregarded the determination of the ecclesiastical court and made its own investigation to determine the validity of the acts in light of the church constitution. The decision was based on the theory, employed by other state courts as well,[16] that the constitution was a contract and that, therefore, the court was under a duty to construe and enforce the agreement.[17] In other state decisions judicial review of determinations by ecclesiastical tribunals has been based upon an implied trust doctrine,[18] in which the courts have undertaken to discover the intent of the donor at the time the property was acquired by the church and thus to prevent a trust diversion.[19] In an effort to avoid the difficulties of determining the donor's intent, the court in *Hughes v. Grossman*[20] awarded the property to the group that followed the doctrine it determined had last been accepted by the rival factions.

In the instant case the Court, after reviewing earlier decisions,[21]

---

myself to understand what these principles were . . . and I have made the attempt to understand it, till I find it, at least, on my part to be quite hopeless . . . . [A]fter racking my mind again and again upon the subject, I really do not know what more to make of it." Craigdallie v. Aikman, 4 Eng. Rep. 435, 440-41 (H.L. 1820) (Scot.).

13. *E.g.*, Saint John's Presbytery v. Central Presbyterian Church, 102 So. 2d 714, 719 (Fla. 1958).

14. *E.g.*, Chatfield v. Dennington, 206 Ga. 762, 58 S.E.2d 842 (1950); Parker v. Harper, 295 Ky. 686, 175 S.W.2d 361 (1943); Landrith v. Hudgins, 121 Tenn. 556, 120 S.W. 783 (1907); Beard v. Francis, 43 Tenn. App. 513, 309 S.W.2d 788 (1957).

15. 121 Tenn. 556, 120 S.W. 783 (1907).

16. *E.g.*, Boyles v. Roberts, 222 Mo. 613, 121 S.W. 805 (1909); Bear v. Heasley, 98 Mich. 279, 57 N.W. 270 (1893); Watson v. Garvin, 54 Mo. 353 (1873); Watson v. Avery, 65 Ky. (2 Bush) 332 (1867).

17. "The constitution is the contract of association in churches and . . . is binding upon all portions of the church . . . . To pass upon the meaning of such [an] instrument is not dealing with ecclesiastical questions at all, but only determining the meaning of an organic agreement or contract." Boyles v. Roberts, 222 Mo. 613, 677, 121 S.W. 805, 821 (1909).

18. While the implied trust doctrine is still employed in most states, it is usually applied in cases involving disputes in a congregational or independent church, where the authority rests with the members of the congregation, rather than in the representative or presbyterian church, where the authority is vested in a superior organization.

19. *E.g.*, Horsman v. Allen, 129 Cal. 131, 61 P. 796 (1900); Kuns v. Robertson, 154 Ill. 394, 40 N.E. 343 (1895).

20. 166 Kan. 325, 201 P.2d 670 (1949).

21. The Court reviewed its holdings in Kreshik v. Saint Nicholas Cathedral, 363 U.S. 190 (1960), Kedroff v. Saint Nicholas Cathedral, 344 U.S. 94 (1952), Gonzales v. Archbishop, 280 U.S. 1 (1929), and Watson v. Jones, 80 U.S. (13 Wall.) 679 (1871).

concluded that the first amendment places severe restrictions on the power of a civil court to interfere with the free exercise of religion. Consequently, the Court reasoned, there are constitutional limitations on the role of civil courts when disputes arise involving church property; but the bare fact that church property is involved will not prevent a civil court from deciding a controversy. The first amendment, continued the Court, simply commands civil courts to resolve disputes over church property without the interpretation and weighing of particular church doctrine. The Georgia Supreme Court's application of the implied trust and "departure-from-doctrine" theories required it to determine whether actions of the petitioner constituted a "substantial departure" from the fundamental religious doctrine existing at the time the local churches became affiliated. Such a determination, observed the Court, required (1) an interpretation of the meaning of particular church doctrines, and, if a substantial departure was found, (2) a determination of whether the breach was so fundamental as to require termination of the implied trust on which petitioner's rights rested. Consequently, the Court concluded that the "departure-from-doctrine" element of the Georgia implied trust theory, by involving the courts in these questions concerning religious doctrine, went beyond the role allowed civil courts by the first amendment in cases involving church property.

By the disposition of the instant case, the Court has sustained a constitutional status for the doctrine announced in *Watson*[22] and has taken from civil courts the power to decide controversies over church property based on an interpretation of religious doctrine. Whether the courts elected to proceed under a so-called contract theory, a doctrine of implied trust, as in the instant case, or some similar label, the holdings in this assemblage of decisions were fundamentally a restatement of the policy of civil court involvement in matters of religious doctrine enunciated in *Pearson*. The decision in the instant case avoids a number of difficulties suggested by the policy of judicial involvement. Meaningful freedom of religion necessarily includes the right of a particular church to determine its own doctrine. Under the policy enunciated in the instant case, the church is free to make such a determination through the system of authority it has established for itself and to decide questions of application of its doctrine to

22. The Court stated that Kedroff v. Saint Nicholas Cathedral, 344 U.S. 94 (1952) converted the principle of *Watson*, as qualified by Gonzalez v. Archbishop, 280 U.S. 1 (1929), into a constitutional rule.

contemporary problems. Where a decision turns upon a question of fact that properly would be left to a jury in a civil suit, as in the instant case,[23] the independence of a church is best guaranteed by leaving the choice between reasonable alternatives to the constituted authority within that particular faith rather than to those who represent the general opinion of the community. Where the evidence involves a controversial issue, as is often the case, or where the doctrine of the church is not widely accepted in the community, determination of such issues by civil courts presents a serious threat to independence and to the right to adhere to an unpopular creed. The decision in the instant case guarantees to any church, no matter how insignificant or unpopular its position in the community, inviolability from the restraints of public opinion.

Even aside from the constitutional difficulties recognized by the Court, a contrary approach seems impractical. Where courts in the past have attempted to determine the use to which property was dedicated by finding a donor's unexpressed intent,[24] they have more often than not been faced with the fact that the property was acquired by an association, paid for by contributions collected from many individuals over an extended period of time and enhanced in value and maintained throughout subsequent years by countless others.[25] To avoid the difficulties of such a determination, a routine solution was the use of a fiction that church property was dedicated to the doctrine existing at the time the property was acquired, the effect being to burden subsequent donors who contributed to the purchase or maintenance of the property with the supposed intent of those who perhaps contributed but a fraction of the value.[26] But whether this determination was an answer to the question of a donor's intent, or a resolution under a contract theory, the fact remains that the court still faced the initial task of thrusting itself into the nebulous area of ecclesiastical doctrine to decide questions, no matter what they were labeled, that it was not equipped to answer. Another effect of the decision in the instant case is a rejection of the

23. The jury was instructed to decide whether the actions of the general church "amount to a fundamental or substantial abandonment of the original tenets and doctrines of the [general church], so that the new tenents and doctrines are utterly variant from the purposes for which the [general church] was founded." 393 U.S. at 443-44.

24. If the church property is held under an express trust for the use and benefit of a particular doctrine, even under *Watson* the court will determine the questions involved.

25. *See* C. Zollmann, AMERICAN CHURCH LAW §§ 240, 250, 579 (1933).

26. *Id.*

presumption that the church was intended to remain unaltered though all the world around it might be changing. To so restrict the freedom of the church would invite unacceptable consequences.[27] It is submitted that for the reasons suggested, the position taken in the instant case is more consistent with the American tradition of religious freedom and more likely to assure an equitable determination of the rights to use of church properties.

## Securities Regulation—Insurance Companies—Proxy Solicitation—McCarran-Ferguson Act not a Bar to Federal Securities Laws

Alleging violations of section 10(b) of the Securities Exchange Act of 1934[1] and of rule 10b-5,[2] the SEC sought to enjoin[3] the merger of two stock life insurance companies on the grounds that the defendant, National Securities, failed to disclose in the proxy statements sent to shareholders of Producers Life that defendant

27. In an English case where the court found that a large majority had abandoned the original faith and practice of the church, a minority of about 30 ministers was awarded church property including 800 churches, three universities and over one million pounds. General Assembly of Free Church of Scotland v. Overtoun, [1904] A.C. 515 (Scot.). This case was reversed by an Act of Parliament—Churches (Scotland) Act, 1905, 5 Edw. 7, ch. 12.

1. 15 U.S.C. § 78j(b) (1964):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange— . . .

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

2. 17 C.F.R. § 240.10b-5 (1968):

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

"(a) To employ any device, scheme, or artifice to defraud,

"(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

3. The SEC brought suit pursuant to § 21(e) of the Act, 48 Stat. 900, *as amended*, 15 U.S.C. § 78u(e) (1964).

owned control of both parties to the merger and that the surviving company would assume obligations incurred in the purchase of the defendant's interest in Producers Life.[4] Denial of temporary relief and approval by the Arizona Director of Insurance resulted in the merger of National Life and Casualty Insurance Company with Producers Life Insurance Company to form National Producers Life Insurance Company. Amending its complaint to seek additional relief, the SEC sought court orders unwinding the merger and returning the situation to the *status quo ante*. The Commission requested that defendants account for their unlawful gains and that the court adjust the equities of defendants and Producers Life on a fair and equitable basis, including, if necessary, the subordination of National Securities's interests in National Producers. Defendants argued that the Commission's action was barred by section 2(b) of the McCarran-Ferguson Act[5] and moved for a judgment on the pleadings. The United States District Court for the District of Arizona dismissed the complaint for failure to state a claim upon which relief could be granted, holding that the relief requested was either barred by the McCarran Act or was beyond the scope of the Securities Exchange Act.[6] The Court of Appeals for the Ninth Circuit affirmed, relying on the McCarran-Ferguson Act.[7] On certiorari to the United States Supreme Court, *held*, reversed. A shareholder's exchange of stock after merger constitutes a "purchase or sale" within section 10(b) and rule 10b-5 under the Securities Exchange Act, and the McCarran-Ferguson Act does not preclude a suit by the SEC under the Exchange Act to protect stockholders of an insurance corporation by

---

4. Defendant, National Securities, Inc., was a Colorado corporation doing business in Arizona as a holding company. Defendant owned the controlling interest in the stock of National Life & Casualty Insurance Co., an Arizona corporation. Control of Producers Life Insurance Co. was purchased partly from Producers's directors and partly in the form of treasury stock held by Producers. Defendants sought to obtain approval of a merger by sending proxy statements to Producers's 14,000 stockholders. The assumption of the obligations by Producers would have had the effect of Producers's financing Securities's purchase of control in it.

5. 15 U.S.C. § 1012(b) (1964): "No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance. . . ." Defendants contended that since the Arizona Director of Insurance had ruled that the merger was not inequitable to the stockholders and not contrary to law, as he was required to do under state insurance laws, ARIZ. REV. STAT. ANN. § 20-731 (Supp. 1969), § 2(b) of the McCarran Act barred the suit.

6. SEC v. National Sec., Inc., 252 F. Supp. 623 (D. Ariz. 1966).

7. SEC v. National Sec., Inc., 387 F.2d 25 (9th Cir. 1967).

unwinding a state-approved merger of insurance companies when shareholder approval is procured by material misrepresentations. *SEC v. National Securities, Inc.,* 393 U.S. 453 (1969).

In 1869, in *Paul v. Virginia,*[8] the Supreme Court stated in dictum that "[i]ssuing a policy of insurance [was] not a transaction of commerce," but only a local transaction, governed by local law.[9] The case fathered numerous offspring, each adhering strictly to the language of the leading case,[10] and the rule that the business of insurance was not commerce held sway through August of 1943, when the District Court of Georgia sustained state control of the insurance industry by quashing an indictment under the Sherman Antitrust Act against the South-Eastern Underwriters Association.[11] Pending the appeal of *South-Eastern Underwriters* to the Supreme Court, companion bills were introduced in both Houses of Congress to exempt the business of insurance from the Sherman and Clayton Antitrust Acts.[12] The bills were still under consideration[13] when the Supreme Court held insurance transactions subject to federal regulation under the commerce clause.[14] The decision had an immediate impact upon Congress, and even though a bill passed by the House later died in the Senate,[15] congressional concern ultimately resulted, in 1945, in passage of the McCarran-Ferguson Act,[16] providing that the "business of insurance," and every person engaged in that business, would be subject to state laws which relate either to

8. 75 U.S. (8 Wall.) 168 (1869).

9. *Id.* at 183.

10. *E.g.,* Western Live Stock v. Bureau of Revenue, 303 U.S. 250 (1938); Bothwell v. Buckbee, Mears Co., 275 U.S. 274 (1927); New York Life Ins. Co. v. Deer Lodge County, 231 U.S. 495 (1913); New York Life Ins. Co. v. Cravens, 178 U.S. 389 (1900); Noble v. Mitchell, 164 U.S. 367 (1896); Hooper v. California, 155 U.S. 648 (1895).

11. United States v. South-Eastern Underwriters Ass'n, 51 F. Supp. 712 (N.D. Ga. 1943). Judge Underwood commented that "[i]f there is to be any overruling of the long line of clear and thoroughly considered decisions of the Supreme Court, acquiesced in for seventy-five years by Congress and administrative agencies, it will have to be done by the Supreme Court itself, or by Congress." *Id.* at 715.

12. S. 1362, 78th Cong., 1st Sess. (1943); H.R. 3270, 78th Cong., 1st Sess. (1943). *See* Note, *Insurance Under the Sherman Act,* 32 GEO. L.J. 66 (1943).

13. *Joint Hearings on S. 1362, H.R. 3269, and H.R. 3270 Before the Subcomms. of the Comms. on the Judiciary,* 78th Cong., 1st & 2d Sess., pts. 1-6 (1943-44).

14. United States v. South-Eastern Underwriters Ass'n, 322 U.S. 533 (1944) (4-3 decision).

15. Objection in the Senate killed the bill without a vote. 90 CONG. REC. 8054 (1944).

16. 15 U.S.C. §§ 1011-15 (1964). The first section of the act clearly declared its policy: "[T]he continued regulation and taxation by the several States of the business of insurance is in the public interest. . . ." 15 U.S.C. § 1011 (1964). The House Report, in its general statement, said that "[t]he committee [had] therefore given immediate consideration to S. 340, together

the regulation or the taxation of that business.[17] The Act specified that no act of Congress would be construed so as to invalidate, impair, or supersede any state law enacted to regulate or tax the business of insurance, unless the act specifically related to insurance.[18] Congress placed a moratorium on the applicability of various federal statutes in order to give the states time to enact legislation.[19] By enacting the McCarran-Ferguson Act, Congress indicated its approval of state regulation and invited the states to deal affirmatively with the insurance business.[20]

Accepting this invitation, Arizona passed comprehensive acts to deal broadly with the insurance industry.[21] Although the legislative

---

with a similar measure, H.R. 1973, so that the several states [would] know that the Congress desire[d] to protect the continued regulation and taxation of the business of insurance by the several States, and thus [enable] insurance companies to comply with State laws." H.R. REP. No. 143, 79th Cong., 1st Sess. 2 (1945). To the same effect, see S. REP. No. 20, 79th Cong., 1st Sess. (1945).

17. Senator McCarran (D-Nev.), co-author of the bill, noted that: "It is not required that the assertion of State regulatory authority . . . shall provide the most effective regulation possible or that it shall be equally strict as the applicable federal law in the same field. Congress has recognized the right of the States to apply their own public policy in the regulation of the business of insurance." McCarran, *Federal Control of Insurance*, 34 A.B.A.J. 539, 541-42 (1948). Senator McCarran commented that there would only be two ways federal power could be brought to bear upon the business of insurance: (1) through the enactment of new legislation, or (2) through enforcement of the federal antitrust laws where there was no applicable state law. As to the second possibility: "The sole question, with respeet to any practice complained of, will be whether that practice is regulated by State law. . . . The inquiry will be: 'Is this practice regulated by State Law?'—not 'Is it effectively regulated?' " *Id.* at 542.

18. 15 U.S.C. § 1012(b) (1964). Senator Ferguson (R-Mich.), co-author of the bill, noted that § 1012(b) of the Aet was written in such a way as to make implied repeal of the act impossible. No existing law or future law would be applied to the business of insurance unless Congress specifically provided that the law would apply to insurance. 91 CONG. REC. 481, 1487 (1945).

19. The moratorium was initially to last until January 1, 1948, but was later extended to June 30, 1948. If the states had not acted by that time, the federal laws would have been enforced. The statutes affected were the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Anti-Discrimination Act. 15 U.S.C. § 1013 (1964). Section 1014 listed three statutes that would be unaffected by the Act. The Court of Appeals in the instant case found it signifieant that Congress named acts which it felt would otherwise have fallen within the exemption. 387 F.2d at 30 (1967). There is no mention of the Securities Act of 1933 or the Securities Exchange Act of 1934 in the McCarran-Ferguson Act. *See* 15 U.S.C. §§ 1012(b), 1013, 1014 (1964). According to Senator O'Mahoney (D-Wyo.); "In drafting [the McCarran Act] we sought to spell out each particular law which might apply to insurance. . . . In other words, a good faith attempt was made to specify every single law which had an applieation, or might have an application, to insurance." 91 CONG. REC. 483 (1945).

20. Prudential Ins. Co. v. Benjamin, 328 U.S. 408, 429, 431 (1946); McCarran, *supra* note 17, at 540.

21. ARIZ. REV. STAT. ANN. §§ 20-441 *et. seq.* (1956).

history of the McCarran-Ferguson Act offers no definition of the phrase "business of insurance," Congress' primary concerns seem to have been the relationship between insurance rate-making and the antitrust laws and the power of the states to tax insurance companies.[22] As part of its regulation of the insurance business, Arizona,[23] like at least thirty other states,[24] regulates insurance company mergers. The Arizona statute provides that no merger or consolidation shall be consummated without the written approval of the Director of Insurance. The approval will be given unless the Director finds the merger contrary to law, inequitable to the stockholders, or tending to reduce substantially the security of and services rendered to the policyholders.[25] In response to the 1964 amendments to the Securities Exchange Act,[26] Arizona law also gives the Director of Insurance the power to determine whether a full disclosure of relevant facts has occurred in connection with the solicitation of proxies.[27] The question thus remains whether the

22. *See, e.g.*, 91 CONG. REC. 1087-88 (1945) (remarks of Congressmen Hancock and Celler). The committee reports are unilluminating. *See* H.R. REP. No. 143, 79th Cong., 1st Sess. (1945); S. REP. No. 20, 79th Cong., 1st Sess. (1945).

23. ARIZ. REV. STAT. ANN. §§ 20-731 (Supp. 1969), 20-733 (1956).

24. *E.g.*, ARK. STAT. ANN. §§ 66-4245, 66-4246 (1966); FLA. STAT. ANN. §§ 628.451 (Supp. 1969), 628.471 (1960); IDAHO CODE ANN. §§ 41-2856, 41-2857 (1961); KY. REV. STAT. § 304.952 (1963); MONT. REV. CODES ANN. §§ 40-4745, 40-4746 (1961); WASH. REV. CODES ANN. § 48.31.010 (1961). For merger procedure and its approval by public supervisory authority, see ABA SUBCOMM. OF THE PUBLIC REG. OF THE BUS. OF INS. COMM. OF THE SECTION OF INS., NEGL., AND COMP. LAW, MERGER OF INSURANCE COMPANIES 137-65 (1966).

25. ARIZ. REV. STAT. ANN. § 20-731(B) (Supp. 1969).

26. Pub. L. 88-467, 78 Stat. 565 (codified in scattered sections of 15 U.S.C.). 15 U.S.C. § 73*l*(g)(2)(G) (1964), provides that the registration requirements for securities shall not apply in respect of:

"(G) any security issued by an insurance company if all of the following conditions are met:

"(i) Such insurance company is required to and does file an annual statement with the Commissioner of Insurance (or other officer or agency performing a similar function) of its domiciliary State, and such annual statement conforms to that prescribed by the National Association of Insurance Commissioners or in the determination of such State commissioner, officer or agency substantially conforms to that so prescribed.

"(ii) Such insurance company is subject to regulation by its domiciliary State of proxies, consents, or authorizations in respect of securities issued by such company and such regulation conforms to that prescribed by the National Association of Insurance Commissioners.

"(iii) After July 1, 1966, the purchase and sales of securities issued by such insurance company by beneficial owners, directors, or officers of such company are subject to regulation (including reporting) by its domiciliary State substantially in the manner provided in section 78p of this title."

27. ARIZ. REV. STAT. ANN. § 20-143 (Supp. 1969). This did not become effective until March 23, 1966.

McCarran-Ferguson Act's sanction of state insurance regulation was intended to include securities regulation. The Supreme Court rejected an argument based on the McCarran-Ferguson Act in *SEC v. Variable Annuity Life Insurance Co. (VALIC)*,[28] holding that adequate state regulation would not bar federal regulation of variable annuity contracts where their essential character is that of securities rather than insurance. Following *VALIC*, the Court held in *SEC v. United Benefit Life Insurance Co.*[29] that certain annuity contracts issued by insurance companies could not be offered to the public without conforming to the registration requirements of the Securities Act of 1933.

At the outset the Court addressed itself to the question of what Congress had intended when it passed the McCarran-Ferguson Act, allowing the states to regulate the "business of insurance." The Court concluded that the focus of that statutory phrase was on the relationship between the insurance company and the policyholder in the contract of insurance.[30] Statutes aimed at that relationship, directly or indirectly, are laws regulating the "business of insurance." However, the Court noted, at least part of the Arizona statute[31] was not aimed at the "insurance" relationship, but instead focused on protection of insurance company stockholders and, as such, was not within the scope of the McCarran-Ferguson Act. Acknowledging that Arizona law requires the Director of Insurance to find that a proposed merger will not substantially reduce the security of or services rendered to policyholders before he can approve the merger,[32] the Court noted that although this clearly relates to the business of insurance, in the circumstances of this particular case the McCarran-Ferguson Act will not bar a federal remedy which affects a matter subject to state insurance regulation.[33] The Court reasoned that the Commission did

28. 359 U.S. 65 (1959).

29. 387 U.S. 202 (1967).

30. The Court reasoned that under *Paul v. Virginia* (see text accompanying notes 8-11 *supra*) the states had freedom in regulating the dealings between insurers and their policyholders. When *South-Eastern Underwriters* threatened continued state control, Congress attempted to turn back the clock. The House Report, H.R. REP. No. 143, 79th Cong., 1st Sess. 3 (1945), makes it clear that Congress did not intend "to clothe the States with any power to regulate or tax the business of insurance beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the *Southeastern Underwriters Association* case." Congressional concern was with state regulation dealing with the *contract* of insurance, the transaction *Paul v. Virginia* had held was not commerce. 393 U.S. at 459.

31. ARIZ. REV. STAT. ANN. § 20-731(B)(2) (Supp. 1969).

32. *Id.* § 20-731(B)(3) (Supp. 1969).

33. The Court would not intimate any opinion about what remedies might be appropriate, holding only that there was no reason to refuse the remedies sought by the Commission. 393 U.S. at 462. The Court declined to express any opinion on the district court's holding that

not ask the trial court to pass directly upon the merger approved by the Director of Insurance; instead, the gravamen of the complaint related to misrepresentation to stockholders, and as such was unrelated to state approval based on adequate protection of policyholders. Thus Arizona's interest in protecting policyholders under the McCarran-Ferguson Act is not infringed upon by the paramount federal interest in insuring "that insurance companies speak the truth when talking to their shareholders."[34]

Because a simple remand of the case from the pretrial dismissal of the complaint would leave several issues unresolved, the Court found it desirable to dispose of two remaining issues before remanding the case.[35] In response to the contention that the complaint failed to allege a "purchase or sale" of securities within the meaning of section 10(b), the Court rejected the applicability of the "no-sale doctrine"[36] and determined that in the context of section 10(b)[37] the broad antifraud purposes of the statute and the rule would be furthered by finding that shareholders had "purchased" shares in the new company by exchanging them for their old stock.[38] The Court similarly rejected the contention that rule 10b-5 does not cover proxy

---

some of the relief requested was beyond the scope of § 21(e) of the Securities Exchange Act of 1934, 48 Stat. 900, *as amended*, 15 U.S.C. § 78u(e) (1964). 393 U.S. at 462 n.5. *See* SEC v. National Sec., Inc., 252 F. Supp. 623, 626 (D. Ariz. 1966).

34. 393 U.S. at 463.

35. Mr. Justice Harlan, although agreeing with the Court's construction of the McCarran-Ferguson Act, said that he was at a loss to understand why the Court found it necessary to go further, since the court of appeals reached no further questions and the government's petition for certiorari was limited to the sole issue of "whether the McCarran-Ferguson Act . . . precludes the application of the anti-fraud provisions of the Securities Exchange Act of 1934." In fact the Solicitor General believed the further questions were not appropriately before the Court. 393 U.S. at 470. Mr. Justice Black dissented, believing the court of appeals correctly decided the case.

36. 17 C.F.R. § 230.133 (1968). That rule the Court points out is specifically made applicable only to cases involving § 5 of the Securities Act of 1933, and sets forth various situations involving statutory mergers and other types of corporate reorganization, declaring that no "sale" or "offer" shall be deemed to be involved. 393 U.S. at 466.

37. Even when there is interdependence of various sections of the securities laws, the meaning of particular phrases must be determined in context. SEC v. C.M. Joiner Leasing Corp., 32 U.S. 344, 350-51 (1943).

38. By voting in favor of the merger an approving shareholder lost any right under Arizona law to obtain an appraisal of his stock and payment for it in cash. This, the Court said, affected the shareholder in ways not at all unlike a typical cash sale or share exchange. 393 U.S. at 467. The governing Arizona statute, ARIZ. REV. STAT. ANN. § 10-347 (1956), provides in part: "Any shareholder of the corporations consolidating who votes to reject the agreement, and who does not consent to the agreed manner of converting the shares of stock, shall be paid in cash the fair value of stock."

solicitations. Although section 14 of the Securities Act of 1934[39] and the rules[40] adopted pursuant to that section set up a regulatory scheme for proxy solicitation, that fact, in and of itself, did not affect the scope of section 10(b) and rule 10b-5 and was thus no bar to their application in the instant case.[41]

The Supreme Court has decided that the federal policy of allowing state regulation of the "business of insurance," as codified in the McCarran-Ferguson Act, is limited to state regulation of the insurance company-policyholder relationship, while the insurance company-stockholder relationship is not immune to federal regulation.[42] A more difficult question arises in the Court's refusal to limit itself to the issue raised by the Government in its petition for certiorari, and its entrance into "virgin territory," albeit cautiously, to construe section 10(b) and rule 10b-5. Although clearly dictum, the Court concluded that the contention that rule 10b-5 does not cover misrepresentations occuring in connection with proxy solicitations could be dismissed "rather quickly."[43] But in disposing of the issue in one paragraph, the Court ignores the Securities Exchange Act Amendments of 1964, which exempt insurance companies from 1934 Act registration and hence from the proxy provisions.[44] By these

39. 15 U.S.C. § 78n (1964).

40. 17 C.F.R. §§ 240.14a-1 to 240.14a-103 (1968). The acts complained of would have fallen within the prohibitions and rules of the proxy-solicitation, anti-fraud provision of § 14 of the 1934 Act, *supra* note 39, but for the fact that the stock of the insurance companies had never been registered on a national securities exchange. By virtue of the 1964 Amendments to the Securities Act, coverage under § 14 was extended to corporations similarly situated to the insurance companies in this action. This coverage is conditioned on an exemption for all insurance companies subject to certain defined state regulation. 15 U.S.C. § 78*l*(g)(2)(G) (1964).

41. The Court distinguished the concededly overlapping effects of the two sections by noting that § 10(b) applies to all proscribed conduct in connection with a purchase or sale of a security, while § 14 applies to all proxy solicitations, whether or not in connection with a purchase or sale.

42. This conclusion was reached at an earlier date by Congress: "Stock insurance companies are presently subject to the provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934." S. REP. No. 379, 88th Cong., 1st Sess. 36 (1963). "Insurance companies' securities are not exempt from the Securities Act or the Exchange Act. . . . State regulation of insurance companies is directed to the protection of the holders of insurance policies, not investors in insurance company securities, as to whom the State regulation has been described as 'less and less meaningful' when matched against the 'more and more relevant' disclosure policy of the Securities Act." REPORT OF SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 95, 88th Cong., 1st Sess. pt. 3, 40 (1963).

43. 393 U.S. at 468.

44. A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5, § 6.5(1), 136 n.92(3) (1968). H.R. REP. No. 1418, 88th Cong., 2d Sess. 2 (1964): "The securities of stock insurance

amendments Congress expressly relinquished its supervision of the area, giving state insurance commissioners an opportunity to demonstrate their ability to protect investors as well as policyholders.[45] It was pursuant to the 1964 amendments that Arizona granted the Director of Insurance the power to make regulations concerning proxies for companies not having registered securities. Further, since the federal amendment and state laws both became effective in 1966, after the instant case first appeared in the courts, it is highly questionable whether section 10(b) and rule 10b-5 should be construed now in such a way as to provide federal regulation in an area Congress believed it had expressly exempted.[46] In rebuttal, it may be argued that what Congress relinquished, knowingly or otherwise, was merely its "regulation" of the area,[47] and that it had no intention of depriving an aggrieved party or the SEC of any implied action under the proxy rules[48] and rule 10b-5. Rule 10b-5 could then be directed against insurance company proxies to provide a remedy that would otherwise be lacking.[49]

The questions then arise as to what standard should apply and what conduct should constitute violation of rule 10b-5. Nothing succeeds like success, and with each successful application of rule 10b-5, its use increases.[50] The absence of standards to be applied in using

companies may become exempt if under State law or regulation there are comparable requirements as to information, proxy solicitation, and insider short-term trading."

45. During the hearings on the amendments, witnesses objected to federal regulation on jurisdictional grounds, rather than grounds relating to the protection of investors: "[T]hese witnesses opposed departure by the bill from the doctrine embodied in the McCarran Act that the regulation of insurance companies be left to the States." The committee adopted the exemption following the testimony of a number of state insurance commissioners and representatives of stock insurance companies. H.R. REP. No. 1418, 88th Cong., 2d Sess. 10 (1964).

46. Relevant portions of the 1964 amendments are quoted in note 26 *supra*.

47. See note 26 *supra* for the language of the exemption, noting that the insurance companies will be subject to regulation, *i.e.*, administrative supervision and specification of contents, instead of remedies. A. BROMBERG, *supra* note 44.

48. SEC Rule 14a-9(a), 17 C.F.R. 240.14a-9(a) (1968), provides that: "[N]o solicitation subject to this regulation shall be made by means of any proxy statement . . . or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." *Compare* this to rule 10b-5, note 2 *supra*. In J. I. Case Co. v. Borak, 377 U.S. 426 (1964), the Court sustained a shareholder's implied right of action in a merger allegedly based on violation of the proxy rules.

49. There is no express provision of relief for misleading statements in proxies of unregistered companies; a registered company whose proxies must be filed with the SEC is subject to the remedies of § 18 of the Exchange Act. 15 U.S.C. § 78(r) (1964).

50. Neil Kennedy commented that: "I think 10b-5 maybe has put a lot of fun in it for the

rule 10b-5 would seem to the purist an invitation for its supplantation of the Securities Acts.[51] Mr. Justice Harlan, in his dissenting opinion, noted that the courts and commentators have vigorously debated whether rule 10b-5 should be read as a sweeping prohibition against fraud that will absorb more limited liability provisions, thus rendering them a nullity, and he suggested that the issues involved are far too important to decide without a full argument by both sides.[52] It is submitted that the Court should not so readily give rule 10b-5 the qualities of a dry sponge, ready to absorb express statutory provisions in which Congress has detailed specific requirements for burdens of proof, defenses, and statutes of limitation.[53] The ultimate effect of the Court's construction of the rule will become evident only with the passage of time, but certainly those who argued for a broad application should look forward to further satisfaction from the courts.

The Court also found it necessary to deal with the meaning of the phrase "in connection with the purchase or sale of any security," found in rule 10b-5. Many of the cases dealing with this phrase have dealt with questions of standing under section 10(b) and rule 10b-5. *Birnbaum v. Newport Steel Corp.*[54] was interpreted to mean that only a person defrauded in connection with his own "purchase" or "sale" could take advantage of section 10(b) and rule 10b-5; but the demise of the *Birnbaum* doctrine has accelerated during the last few years,[55] and this trend has been applauded.[56] The instant case,

investigators because almost whatever happens they can come up with a theory that 10b-5 has somehow been violated." Panel Discussion, *The Emergence of "Federal Corporation Law" and Federal Control of Inside Information*, 34 U. MO. K.C.L. REV. 228, 229 (1966).

51. An obvious solution would be to rewrite rule 10b-5 or § 10(b) of the Exchange Act of 1934. The SEC has authority to change the rule, but it would seem unlikely that it would care to limit its regulatory or disciplinary authority. Congressional action raises questions concerning the desirability of codifying the developments under the rule without simply creating a host of new problems.

52. 393 U.S. at 472.

53. Professor Bromberg analogizes the absorption process to "that by which the due process clause of the fourteenth amendment seems to be absorbing the Bill of Rights and applying it to the states." A. BROMBERG, *supra* note 44, at § 2.5, 41 (1968). Another writer sees less practicability in the developments under rule 10b-5: "What lies ahead under rule 10b-5? The only prospect which I can see in all candor, is—More chaos. . . . [P]erhaps each lawyer should consider equipping his client with a shoe-phone, so that he can be in touch with him day and night to combat the forces of Kaos." Marsh, *What Lies Ahead Under Rule 10b-5?*, 24 BUS. LAW. 69, 75-76 (1968).

54. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

55. Lowenfels, *The Demise of the "Birnbaum' Doctrine: A New Era for Rule 10b-5*, 54 VA. L. REV. 268, 271-75 (1968).

56. *Id.;* Note, *The Purchaser—Seller Limitation to SEC Rule* 10b-5 53 CORNELL L. REV. 684, 694-97 (1968).

however, involves none of the standing questions, but instead relates only to the scope of the statutory coverage. The Court's conclusion that shareholders "purchase" shares in a new company by exchanging them for their old stock seems substantially correct, and however far it broadens the definition of "purchase" or "sale," it does no violence to the language of the rule,[57] since such a construction provides needed stockholder protection in a time of increasing mergers.

## Secnrities Regulation—Punitive Damages Awarded in Action Under Section 17(a) of the Securities Act of 1933, While Underwriter's Indemnification Agreement Held Void as Against Puhlic Policy Where Underwriter Knows of Material Inaccnracy in Offering Circular

Thirteen purchasers of newly issued common stock charged defendant corporation, two of its officers,[1] and an investment banking firm with violations of the federal securities laws[2] and common-law

57. Note, however, that although few will argue with the Court's decision on this question, it should be considered dictum, since the issue was not raised for formal argument.

1. Elias Hoppenfeld, the president of defendant Law Research Service, Inc., was named a defendant in the original complaint. Paul Weiner, treasurer and director of the corporation, was named a third party defendant in a cross-claim filed also against Hoppenfeld and the corporation by Blair & Co., the underwriter.

2. Hoppenfeld and Blair & Co. were charged with violations of § 17(a) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934, and common-law fraud. In addition, Blair & Co. was charged with violations of § 12(2) of the 1933 Act and § 15(c) of the 1934 Act.

Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77q (1964), provides: "It shall be unlawful for any person in the offer or sale of any securities . . . directly or indirectly

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or any property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j (1964), provides: "It shall be unlawful for any person . . .

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of the investors."

fraud,[3] due to the alleged omission of material facts[4] from certain sales literature required by the Securities and Exchange Commission.[5] The underwriter asserted a cross-claim against the issuing corporation and its officers based on an idemnification agreement,[6] despite the fact that the underwriter had knowledge of the alleged material omission in the circular. The jury returned a verdict in favor of the plaintiffs on all counts of federal securities acts violations, but acquitted the defendants on the common-law fraud count. The jury also awarded punitive damages against the investment banking firm and the issuing corporation's president under section 17(a) of the Securities Act of 1933.[7] At the same time, the jury granted the underwriter indemnification from the issuer and its president. On a motion to the district court by the corporation and its officers to dismiss the cross-claim, to set aside the verdict and for judgment n.o.v., *held*, cross-claim dismissed. Punitive damages may be awarded under section 17(a) of the Securities Act of 1933 for conduct contrary to the public interest involving a high degree of moral culpability, and enforcement of the indemnification agreement would contravene the public policy embodied in the federal securities acts. *Globus v. Law Research Service, Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968).

Section 12(2) of the 1933 Act, 15 U.S.C. § 77*l* (1964), provides for the return of the price paid by one who sells a security with misleading statements less the amount of the income earned on the security.

Section 15(c) of the 1934 Exchange Act, 15 U.S.C. § 78*o* (9)(c)(1) (1964), provides: "No broker or dealer shall . . . induce the purchase or sale of any security . . . by means of manipulative, deceptive, or other fraudulent device or contrivance."

3. For a discussion of common-law fraud, see W. PROSSER, TORTS § 100 (3d ed. 1964).

4. Defendant Law Research Service, Inc., had been engaged in a law information retrieval system using the computers and programming services of the Univac Division of Sperry-Rand Corp. The offering circular, which bore the name of Blair & Co. as underwriters, prominently mentioned the "Sperry-Rand Contract" and indicated that Sperry-Rand was contributing to the success of the venture. In fact, the contract had been terminated, and the matter was presently in litigation. As a consequence, no services were being provided by Sperry-Rand, a fact apparently known by all defendants.

5. The information was omitted from the offering circular, which is required by Regulation A, promulgated by the SEC pursuant to the Securities Act of 1933 § 3(b), 15 U.S.C. § 77c(b) (1964). The Commission is authorized to exempt from registration offerings of less than $300,000 "if it finds that the enforcement of this subchapter with respect to such securities is not in the public interest." 15 U.S.C. § 77(b) (1964). In such unregistered offerings, the offering circular performs a function similar to that of a prospectus in the case of a registered security. *See* SEC Reg. A, 17 C.F.R. § 230.251-.263 (1968).

6. Law Research was to indemnify Blair & Co. for any loss arising out of untrue statements of a material fact in the offering circular, unless the underwriters were guilty of a willful misfeasance, bad faith or gross negligence in the performance of their duties or recklessly disregarded their obligations and duties under the underwriting agreement.

7. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q (1964). *See* note 2 *supra*.

Section 17(a) of the 1933 Securities Act[8] declares unlawful the making of an untrue statement or the omission of a material fact which would mislead the investor.[9] Unlike common-law fraud, where both a specific intent to defraud and a justifiable reliance on the fraudulent misrepresentation must be shown,[10] the plaintiff in a section 17(a) case must show only the defendant's actual knowledge of the statement's falsity and the materiality of the inaccuracy.[11] In common-law fraud cases it is generally recognized that punitive damages, in addition to compensatory damages, are recoverable in order to deter[12] acts which amount to gross fraud[13] or a reckless indifference to the rights of others.[14] Section 28(a) of the 1934 Act, which limits damages to "actual damages complained of,"[15] has been said to exclude punitive damages.[16] Since there is no limitation similar to section 28(a) of the 1934 Exchange Act in the 1933 Act, one court has said in dictum that punitive damages are appropriate for a claim based on section 17(a) of the 1933 Act.[17]

Mutual indemnification agreements are inserted in prospectuses or offering circulars as a matter of form.[18] In the typical agreement

---

8. See note 2 *supra*.

9. A material fact is one "which if it had been stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question." Charles A. Howard, 1 S.E.C. 6, 8 (1934); *cf.* List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

10. For a discussion of common-law fraud, see W. PROSSER, TORTS § 100 (3d ed. 1964).

11. *See, e.g.*, Dack v. Shanman, 227 F. Supp. 26 (S.D.N.Y. 1964) (count lacking allegations necessary to action in fraud and deceit sufficient for cause of action under securities acts); Ellis v. Carter, 291 F.2d 270 (9th Cir. 1961) (fraud need not be shown; mere misstatement sufficient). For cases and articles supporting various views on the amount of knowledge required for securities fraud, see Globus v. Law Research Service, Inc., 287 F. Supp. 188, 197 (S.D.N.Y. 1968).

12. The use of punitive damages as a deterrent factor is discussed in Walker v. Sheldon, 10 N.Y.2d 401, 406, 179 N.E. 2d 497, 499, 223 N.Y.S.2d 488, 492 (1961).

13. *E.g.*, Greene v. Keithly, 86 F.2d 238, 242 n.1 (8th Cir. 1936).

14. In Fink v. Boyer, 331 Mo. 1242, 56 S.W.2d 372 (1932), the court held that where the fraudulent act was done without just cause or excuse, punitive damages may be awarded. An Indiana court extended this idea to negligent misrepresentations where the seller could have discovered the truth. Wheatcraft v. Myers, 57 Ind. App. 371, 107 N.E. 81 (1914).

15. Securities Exchange Act of 1934 § 28(a), 15 U.S.C. § 78bb (1964); *See generally* 3 L. LOSS, SECURITIES REGULATION 1793 (1961); Shulman, *Civil Liability and the Securities Act*, 43 YALE L.J. 227 (1933); Comment, *Private Remedies Available Under 10b-5*, 20 SW. L.J. 620, 623 (1966).

16. Mills v. Sarjem Corp., 133 F. Supp. 753, 769-70 (D.N.J. 1955) (dictum).

17. Nagel v. Prescott, 36 F.R.D. 445 (N.D. Ohio 1964).

18. For an example and discussion of the standard form, see Lockwood & Anderson, *Underwriter Contracts, Within Purview of Securities Act of 1933; With Certain Suggested Provisions*, 8 GEO. WASH. L. REV. 33 (1939).

each of the parties agrees to indemnify the other for any loss that may occur because of a material inaccuracy within the indemnitor's sphere of expertise.[19] The federal securities laws do not deal directly with indemnification agreements,[20] but a policy expression in SEC Rule 460 indicates that the Commission views indemnity agreements which favor directors, officers and controlling persons as against public policy in that they contradict the deterrent purpose of the imposition of liability.[21]

In the instant case, the court indicated that the standard to be applied in awarding punitive damages is whether the defendants' conduct involved a high degree of moral culpability; the test does not include the technical requirements of common-law fraud.[22] The court found that there was ample evidence to support the finding that the underwriter had actual knowledge of the material facts omitted from the offering circular and, therefore, the underwriter was guilty of deliberate wrongdoing in distributing the circular without revealing those facts. Although the liability arose from a violation of a statute which did not expressly allow punitive damages, the court argued that this did not prevent it from sustaining such an award. It noted other applications of punitive damages to implied civil liability arising from legislative authority[23] and pointed out that the award complemented the purpose of the antifraud provision of the 1933 Act. Further, the court reasoned that if Congress had wished to impose a restriction against punitive damages in the 1933 Act as it did in the 1934 Act, it would have done so. The court added that the plaintiffs had not forfeited their rights to punitive damages under the 1933 Act by asserting an action under 10(b) of the 1934 Act, since section 28(a) of the 1934 Act provides that the remedies in that Act are cumulative rather than exclusive. Even though the jury's verdict did not designate whether section 17(a) of the 1933 Act or section 10(b) of the 1934 Act had been violated, the court upheld the punitive damages award

19. For a discussion of the extent of fiduciary responsibility of underwriters, accountants, lawyers and directors, see Escott v. BarChris Constr. Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); Note, *The Underwriter's Duty of "Due Diligence" Under Section 11 of the Securities Act: Reflections on BarChris*, 22 VAND. L. REV. 386 (1969).

20. Section 14 of the 1933 Act, 15 U.S.C. 77n (1964), does, however, void any provision binding any purchaser to waive compliance with either the Act or SEC rules.

21. SEC Rule 460, 17 C.F.R. § 230.460 Note (1968). *See* argument and cases cited in Note, *Indemnification of Underwriters and Section 11 of the Securities Act of 1933*, 72 YALE L.J. 406, 408-10 (1962); *see also* Chabot v. Empire Trust Co., 301 F.2d 458 (2d Cir. 1962).

22. See text accompanying notes 9-17 *supra*.

23. 287 F. Supp. at 194.

because the elements of a violation under either section are the same. Furthermore, the court found that intent to deceive was not an element of securities fraud, since Congress could have used "time honored classic phrases" to describe the concept, but instead chose words referring primarily to conduct. In addition, the court reasoned that intent to defraud is not required for criminal penalties; consequently, to require a civil plaintiff to prove intent to defraud would be an anomalous result. Finally, the court ruled that the defendants were estopped from asserting that the omission had not caused plaintiffs' damage, since the parties had previously agreed on the amount of damages in the event that a court determined that defendants had violated the federal securities laws.

The court held that in the situation where the underwriter has actual knowledge of the material inaccuracy in the offering circular, the indemnification agreement is void as against public policy. The threat of liability is imposed to encourage thorough investigation and truthfulness in the prospectus, and the court refused to frustrate that purpose by allowing the underwriter to escape liability through indemnification. Despite the fact that the corporation's officers were "more guilty" than the underwriter, the court denied recovery under the indemnification agreement because the underwriter had not performed its duties with due care.[24] By awarding punitive damages under section 17(a) of the 1933 Act[25] and striking the indemnity clause, the court has significantly strengthened the powerful weapon of private enforcement of the federal securities laws. Private enforcement is a necessity, since the SEC presently does not have the resource capability for adequate investigation of registration statements.[26] The fear of litigation and the possibility of prohibitive damages without indemnification encourage caution and diligence in the investigation and preparation of the prospectus. Without this fear, underwriters have had little impetus to thoroughness in their investigations. The court thus properly struck the indemnification agreement in the situation where the underwriter has actual knowledge

24. For a discussion of the relationship of indemnification to the underwriter's duty of care, see Note, *The Underwriter's Duty of "Due Diligence" Under Section 11 of the Securities Act: Reflections on BarChris*, 22 VAND. L. REV. 386 (1969).

25. Although § 17(a) of the 1933 Act applies only to fraudulent sales, its wording is substantially the same as SEC Rule 10b-5, which deals with both purchases and sales; consequently, it is possible that actions for fraudulent sales formerly brought under 10b-5 will now be based on § 17(a) because of the chance for greater damages. See text accompanying note 15 *supra*.

26. Comment, *BarChris: Due Diligence Refined*, 68 COLUM. L. REV. 1411, 1421 (1968).

of material inaccuracy. However, since the court could have reached the same conclusion through interpretation of the indemnification agreement[27] but chose instead to strike the agreement, there is an indication that liability without indemnity could be extended to negligent omission or misstatement. It is submitted that such an extension would be in the public interest. In the securities field, the underwriters, as much as the corporate officers, bear a fiduciary responsibility to the investing public. By definition, an underwriter negligent in his investigation and representations has not acted as a reasonably prudent man; consequently, he should be held accountable. However, the standard of conduct appropriate for the reasonably prudent underwriter is just as uncertain as the amount of damages to be paid if a court decides that the standard has been violated. While the courts of the Southern District of New York have a great deal of experience and acumen in the securities area and are probably eminently qualified to fashion judicial guidelines, other districts are not necessarily so favored. Hence, with the forseeable increase in litigation due to the possibility of punitive damages, there is a distinct chance for inequitable variation not only in the amount of damages awarded, but also in the standard of conduct demanded.[28] It is submitted that only a definite congressional statement or appropriate SEC rules can provide both protection to the investor and certainty to the businessman. For example, the treble damage provision of the Clayton Act[29] has proved to be an effective means of enforcing the antitrust laws while awarding damages to injured parties. A similar provision in the securities laws could eliminate possible inequitable variation in damages awards. The decision in the instant case was predictable and is of great value in the enforcement of securities laws. However, in view of the threat of liability and the present imbroglio under SEC rule 10b-5, it clearly demonstrates the need for guidelines promulgated either by Congress or by the SEC in order to channel the rapid development in this area of law.

27. See note 6 *supra*.

28. In Roginsky v. Richardson-Merrill, Inc., 378 F.2d 832 (2d Cir. 1967), punitive damages were disallowed as to misleading statements regarding the use of a drug made by a drug company. The court commented to the effect that if punitive damages were allowed, the multiplicity of suits in many jurisdictions could aggregate the amount of damages awarded far beyond the amount necessary for "punishment," resulting in "overkill."

29. Clayton Act § 4, 15 U.S.C. § 15 (1964), reads in pertinent part: "Any person . . . injured . . . by reason of anything forbidden in the antitrust laws may sue in district court . . . and shall recover threefold the damages by him sustained, and the cost of suit, including a reasonable attorney's fee."

## Taxation—Accumulated Earnings Tax—Corporation Must Show Absence of Tax Avoidance Motives as One Purpose for Unreasonable Accumulatiou

The Commissioner of Internal Revenue assessed accumulated earnings taxes[1] against respondent, a small, closely held corporation.[2] The taxes were paid, and when a claim for a refund was refused, a suit for recovery was initiated. At the conclusion of the trial, the court rejected the Government's requested instruction which would have permitted the jury to find for the Commissioner if tax avoidance was found to be a purpose for respondent's accumulation.[3] Instead, the court instructed the jury to find for respondent unless tax avoidance was "the purpose" for the accumulation. The jury returned a special verdict indicating that although respondent's accumulation was beyond the reasonable needs of his business, tax avoidance was not "the purpose." The Court of Appeals for the Sixth Circuit reversed, but upheld the trial court's rejection of the Government's proposed instruction, holding that the accumulated earnings tax applied only if tax avoidance was the "dominant, controlling, or impelling motive" for the accumulation.[4] On certiorari to the United States Supreme Court, *held,* reversed. In order to rebut the statutory presumption of tax avoidance created by section 533(a), a corporation must show by

---

1. *See* INT. REV. CODE of 1954, §§ 531-37. Section 531 sets the rates and imposes the tax. Section 532(a) provides that the tax is to be imposed on "every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed." Subsection (b) exempts personal holding companies, foreign personal holding companies, and tax-exempt corporations under subchapter F. Section 533(a) provides that: "[T]he fact that the earnings and profits . . . accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid the income tax with respect to shareholders, unless the corporation by the preponderance of the evidence shall prove to the contrary."

2. These sections are generally applied only to small, closely held corporations. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 69 (1954). The basic purpose of §§ 531-37 is to discourage the use of a corporation as an accumulation vehicle to shelter its individual stockholders from personal income tax rates. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 211 (2d ed. 1966). Only one large corporation has been subjected to the accumulated earnings tax, but in that case the controlling interest was held by a small group of shareholders. *See* Trico Prod. Corp. v. Commissioner, 137 F.2d 424 (2d Cir.), *cert. denied,* 320 U.S. 799 (1943).

3. Donruss Co. v. United States, 384 F.2d 292, 296 (6th Cir. 1967): "[I]t is not necessary that avoidance of shareholder's tax be the sole purpose for the unreasonable accumulation of earnings; it is sufficient if it is one of the purposes for the company's accumulation policy."

4. *Id.* at 298.

a preponderance of evidence that the avoidance of taxes on its shareholders was not one of the purposes of the accumulation. *United States v. Donruss Company*, 393 U.S. 297 (1969).

The accumulated earnings tax is applied to "every corporation . . . formed or availed of for the purpose of avoiding the income tax with respect to its shareholders."[5] Under the 1939 Code, the ultimate question was not whether the corporation had business needs for which accumulations were made, but whether it was formed or availed of for the proscribed purpose.[6] The tax was held applicable where a corporation made reasonable accumulations for business purposes but was also motivated by tax avoidance.[7] The provision in the 1954 Code for a tax credit against all reasonable accumulations now makes the question of intent irrelevant if the accumulations are reasonable.[8] On the other hand, corporations making unreasonable accumulations have not been subjected to the tax where there existed an honest belief of the need to accumulate.[9] There has been some conflict as to the quantum of proof required to rebut the presumption which arises when accumulations are found to be unreasonable in light of planned or anticipated business needs. The First Circuit held in *Young Motor Co. v. Commissioner*[10] that the taxpayer need only show that tax avoidance was not the "primary or dominant purpose which led to the decision," since "the statute does not say 'a' purpose, but 'the' purpose."[11] The same result has been reached in other decisions by

5. INT. REV. CODE of 1954, § 532.

6. Young Motor Co. v. Commissioner, 281 F.2d 488, 490-91 (1st Cir. 1960); B. BITTKER & J. EUSTICE, *supra* note 2, at 218.

7. *E.g.*, Pelton Steel Casting Co. v. Commissioner, 251 F.2d 278 (7th Cir. 1958); Whitney Chain & Mfg. Co. v. Commissioner, 149 F.2d 936 (2d Cir. 1945); United States v. R.C. Tway Coal Sales Co., 75 F.2d 336 (6th Cir. 1935). Where an accumulation was originally for legitimate purposes but was later motivated by tax avoidance, the tax is imposed. Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943).

8. INT. REV. CODE of 1954, § 535(c)(1)(A): "[T]he accumulated earnings credit is . . . an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business."

9. *E.g.*, United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964); T.C. Heyward & Co. v. United States, (W.D.N.C. 1966), *cited in* 18 Am. Fed. Tax R.2d 5775; Bremerton Sun Publishing Co., 44 T.C. 566 (1965). Since "purpose" is the ultimate question, the tax should not be imposed where accumulations are made out of spite, caprice, miserliness or stupidity rather than good business reasons. B. BITTKER & J. EUSTICE, *supra* note 2, at 216. *E.g.* T.C. Heyward & Co. v. United States, *supra*, where the court found the accumulations to be "fantastic" but held for the taxpayer, noting that "one bent upon tax evasion would [not] have the unmitigated gall to attempt it in such an obvious manner." *Id.* at 5775. *Cf.* Smoot Sand & Gravel Corp. v. Commissioner, 274 F.2d 495 (4th Cir. 1960) (reasonable purpose required).

10. 281 F.2d 488 (1st Cir. 1960). *See also* Apollo Indus., Inc. v. Commissioner, 358 F.2d 867 (1st Cir. 1966).

11. 281 F.2d at 491.

analogy to certain provisions of the Code dealing with estate and gift taxes.[12] However, the "dominant purpose" approach has been flatly rejected in some jurisdictions which have dealt with the problem,[13] while others have approved the imposition of the tax if tax avoidance was one of the "determinating purposes."[14] In these jurisdictions the "[taxpayer's] evidence must be directed to [showing] a complete lack of the proscribed purpose."[15]

After determining that the phrase "availed of for the purpose" was inherently vague,[16] the instant Court examined the legislative history of the accumulated earnings provisions and concluded that Congress had not placed any particular significance on the use of the article "the."[17] Instead, congressional policy was seen as favoring the distribution of corporate profits not needed for business purposes so that, when distributed, additional tax liability would be imposed on stockholders.[18] The Court noted that this policy has been implemented

12. For example, although the words of § 2035(a) of the Code do not specify that impending death must be the dominant or controlling factor behind the transfer, courts have consistently so held. *E.g.*, Allen v. Trust Company of Georgia, 326 U.S. 630 (1946); City Bank Farmers Trust Co. v. McGowan, 323 U.S. 594 (1945); United States v. Wells, 283 U.S. 102 (1931). Section 102 of the Code does not specify that the donor's dominant intent must be donative; however that intent must be shown if the transfer is to be treated as a gift. Commissioner v. Duberstein, 363 U.S. 278 (1960).

13. *E.g.*, United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964); Barrow Mfg. Co. v. Commissioner, 294 F.2d 79 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962); Trico Prod. Corp. v. Commissioner, 137 F.2d 424 (2d Cir.), *cert. denied*, 320 U.S. 799 (1943).

14. *E.g.*, Kerr-Cochran, Inc. v. Commissioner, 253 F.2d 121 (8th Cir. 1958); World Publishing Co. v. United States, 169 F.2d 186 (10th Cir. 1948), *cert. denied*, 335 U.S. 911 (1949).

15. Pelton Steel Casting Co., 28 T.C. 153, 174 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958).

16. 393 U.S. at 302.

17. When necessary to effect the legislative purpose, the Court is not bound by a literal reading of the statute. *See* Malat v. Riddell, 383 U.S. 569, 571-72 (1966); Board of Governors v. Agnew, 329 U.S. 441, 446-48 (1947). Respondent stressed the fact that Congress did not use the article "a," although it could have done so, thus indicating that tax avoidance had to be the dominant purpose. This position was accepted in Young Motor Co. v. Commissioner, 281 F.2d 488 (1st Cir. 1960). See notes 10-11 *supra* and accompanying text. The Court in the instant case noted that the Report of the Senate Finance Committee stated: "The proposal is to strengthen [the evidentiary] section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of *any* purpose to avoid surtaxes upon shareholders." S. REP. No. 1567, 75th Cong., 3d Sess. 5 (1938) (emphasis added).

The court of appeals in Donruss Co. v. United States, 384 F.2d 292 (6th Cir. 1967), had concluded, by drawing analogies to certain estate and gift tax provisions of the Code, that the presumption of § 533(a) could be rebutted by showing that tax avoidance was not the dominant purpose. *See* note 12 *supra* and accompanying text. The instant Court summarily rejected this position, stating that the "language, purpose, and legislative history [of the estate and gift tax provisions] are entirely different from that of the accumulated earnings tax." 393 U.S. at 309.

18. *See* Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943). For a

by a progressive reduction in the quantum of proof necessary to show a purpose to avoid taxes upon shareholders,[19] resulting in Congress's provision that a presumption of tax avoidance will arise if accumulations are in excess of reasonable business needs.[20] The Court conceded, however, that congressional realization that legitimate business needs might require accumulation makes the applicability of this presumption dependent upon a showing of unreasonable accumulation. Under these circumstances, the Court concluded the Congress intended the unreasonable nature of the accumulation to be the significant factor in the imposition of the tax; any test requiring tax avoidance to be the primary or dominant purpose for the imposition of the tax is thus contrary to congressional intent. The Court refused to adopt a policy which would upset the needed presumption that arose upon a finding of unreasonable accumulation.[21] Although concurring in result, three Justices dissented on the ground that under the majority opinion a jury was likely to believe that it must find tax avoidance and impose the tax whenever it

discussion of the possible advantages to be gained by the retention of earnings, see Kipperman, *Accumulated Earnings Tax: Burdens of Proof of Reasonableness and Purpose*, 12 TAX COUNSELOR'S Q. 307 n.1 (1968), *reprinted from* 54 CALIF. L. REV. 1050 (1966).

19. The tax was originally imposed on shareholders of corporations "formed or fraudulently availed of for the purpose of preventing the imposition of such [personal income] tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed." Tariff Act of 1913 § II(A)(2), 38 Stat. 114, 166. The problems of proving fraudulent intent led Congress to delete the word "fraudulently." Revenue Act of 1918 § 220, 40 Stat. 1072. *See* S. REP. No. 617, 65th Cong., 3d Sess. 5 (1918). In 1921, following Eisner v. Macomber, 252 U.S. 189 (1920), the tax was shifted from the shareholder to the corporation. Revenue Act of 1921 § 220, 42 Stat. 227, 247. Personal holding companies were exempted from the accumulated earnings tax and were made subject to a tax on undistributed income because such companies, "[b]y making partial distributions of profits and by showing some need for the accumulation of the remaining profits . . . [make] it difficult to prove a purpose to avoid taxes." Revenue Act of 1934 §§ 102, 351, 48 Stat. 702, 751. *See* H.R. REP. No. 704, 73d Cong., 2d Sess. 11 (1934). After recognizing that the difficulty of proving tax avoidance made the accumulated earnings tax relatively ineffective, Congress imposed an undistributed profits surtax on most corporations. Revenue Act of 1936 § 14, 49 Stat. 1655.

20. This presumption was instituted in the 1939 Code and required the taxpayer to prove by a "clear preponderance of the evidence" that tax avoidance was not the purpose if the accumulations were in excess of reasonable business needs. Revenue Act of 1938 § 102, 52 Stat. 483. The Senate report accompanying the bill stated that its purpose was to "strengthen the [accumulated earnings] section by requiring the taxpayer by a clear preponderance of the evidence to prove the absence of any purpose to avoid surtaxes upon shareholders." S. REP. No. 1567, 75th Cong., 3d Sess. 5 (1938). Section 533(a) of the 1954 Code omitted the word "clear" from the phrase "clear preponderance of the evidence," thus somewhat easing the taxpayer's burden.

21. The Court's motivation by the demands of administrative convenience is not new: "A statute which stands on . . . the participants' state of mind may need the support of presumption, indeed [may] be practically unenforceable without it." United Business Corp. v.

is shown that a taxpayer accumulated earnings with knowledge of the resultant tax savings, regardless of any evidence offered by the taxpayer.[22] Alternatively the dissenters suggested that congressional policy would be upheld if the tax is imposed only when it is found that the corporation would have distributed earnings had there been no possibility of tax savings for its stockholders through accumulation.[23]

In order for the taxpayer to prevail in accumulated earnings tax cases, primary emphasis should now be placed on showing the reasonable nature of the accumulation, for once the presumption of tax avoidance is made, the task of overcoming it is formidable.[24] Because of the increasing reliance upon reasonableness as the test of accumulated earnings tax liability, some guidelines should be

Commissioner, 62 F.2d 754, 755 (2d Cir. 1933). "The utility of the badly needed presumption arising from the accumulation of earnings or profits beyond the reasonable needs of the business is well neigh destroyed if that presumption in turn is saddled with [the] requirement of proof of 'the primary or dominant purpose' of the accumulation." Barrows Mfg. Co. v. Commissioner, 294 F.2d 79, 82 (5th Cir. 1961), *cert. denied*, 369 U.S. 817 (1962).

22. 393 U.S. at 311. The majority opinion rejected this argument by stating that "purpose" is still relevant to isolate those cases in which the taxpayer made unreasonable accumulations without the proscribed motive. *Id.* at 308. He may show that "even though knowledge of the tax consequences was present, that knowledge did not contribute to the decision to accumulate earnings." *Id. See* note 9 *supra* and accompanying text.

23. 393 U.S. at 312. While the dissenters apparently agree with the majority as to the result, adoption of their test might well cause reversal. Thus, if the taxpayer showed three valid reasons for the accumulation, one of which was tax avoidance, he may well have made the accumulation even if tax avoidance was not a factor. Any valid business purpose might thus be sufficient to induce accumulation if considered alone. Where tax savings are possible the business purpose may be of only relatively minor importance. In such a case the dissenters' test would permit the presumption of tax avoidance to be rebutted by a showing of any business purpose, however slight, which might have justified accumulation.

24. This is not impossible. *See* note 9 *supra*. Absent the condemned purpose, the effect of tax savings is not alone a foundation for imposition of the additional surtax. R. L. Blaffer & Co., 37 B.T.A. 851 (1938), *aff'd*, 103 F.2d 487 (5th Cir.), *cert. denied*, 308 U.S. 576 (1939); Cecil B. DeMille, 31 B.T.A. 1161 (1935), *aff'd*, 90 F.2d 12 (9th Cir.), *cert. denied*, 302 U.S. 713 (1937). However, the effect is evidence of the purpose, because it can reasonably be inferred that the controlling interests intended the obvious and natural consequences of their acts. Helvering v. National Grocery Co., 304 U.S. 282 (1938). Once the presumption is made, however, many factors militate against the taxpayer. Although the tax bracket of the shareholder is not conclusive as to motive, Commissioner v. Young Motor Co., 316 F.2d 267 (1st Cir. 1963), it is a factor. R. Gsell & Co. v. Commissioner, 294 F.2d 321 (2d Cir. 1961); Carolina Rubber Hose Co., ¶ 65, 229 P-H Tax Ct. Mem. 1282 (1965). Furthermore, the existence of an obvious alternative for achieving the same non-tax end contradicts claims that tax avoidance was not a motive. Whitney Chain & Mfg. Co., 3 T.C. 1109, 1120, *aff'd per curiam*, 149 F.2d 936 (3d Cir. 1945). While lower courts have held that a corporation may finance purchases out of current earnings rather than borrowing, United States v. Duke Laboratories, Inc., 337 F.2d 280 (2d Cir. 1964); Electric Regulator Corp. v. Commissioner, 336 F.2d 339 (2d Cir. 1964)—the Supreme Court has suggested that an accumulation to pay off debt that could be refinanced

established to aid those corporations accumulating income for legitimate business purposes. At present none exist,[25] leaving room for abuse by both the Commissioner[26] and the taxpayer. Although the boundaries of "business purpose" have been defined,[27] no official statement has been made as to what constitutes a "reasonable accumulation" made pursuant to a "definite plan."[28] Theoretically, the nature of the accumulation is to be determined by what a "prudent businessman would consider appropriate for the present business purposes."[29] But while some certainty has been provided by recent decisions[30] making the operating cycle[31] the basis for determining the need for working capital, the same cannot be said for other business needs. A statistical analysis of past needs may be relevant to the determination of the need for future working capital; however, where the accumulation is for an unusual or infrequent business need,[32] it must be justified as reasonable in light of a

---

might be unreasonable. Helvering v. Chicago Stock Yards Co., 318 U.S. 693 (1943). Other indices of intent include: loans to shareholders, loans having no relation to the conduct of business, investments in property or securities unrelated to the taxpayer's business, and retention of earnings and profits to provide against unrealistic hazards. Treas. Reg. § 1.537-2(c) (1968).

25. "Probably the only statement concerning the reasonableness of a corporate accumulation with which the courts, the Treasury Department and corporate taxpayers all agree is that each case requires a factual determination based on the circumstances involved." Weithorn, *What Constitutes a "Reasonable" Corporate Accumulation?*, N.Y.U. 17TH INST. ON FED. TAX. 299, 311 (1959).

26. *See* B. BITTKER & J. EUSTICE, *supra* note 2, at 211-12 n.3: "It is often alleged that revenue agents threaten to assert § 531 deficiencies as a weapon to obtain agreement on other deficiencies. It is inherent in such charges that they are easily made and easily denied, but nearly impossible to substantiate or disprove." In view of the absence of guidelines in the Regulations, such threats might easily result in acquiescence on the part of the taxpayer.

27. Treas. Reg. § 1.537-2(b), 3(a) (1968). Such purposes include: business expansion, improvement of facilities, replacement of equipment, retirement of indebtedness and working capital. Note, *Accumulated Earnings and the Reasonableness Test of Section 537*, 43 TULANE L. REV. 129 (1968).

28. "It is contemplated that this amendment [section 537] will cover the case where the taxpayer has specific and definite plans for acquisition of buildings or equipment for use in the business. It would not apply where the future plans are vague and indefinite, or where execution of the plans is postponed indefinitely." S. REP. NO. 1622, 83d Cong., 2d Sess. 69 (1954). *See* Treas. Reg. § 1.537-1(b)(1) (1968).

29. Treas. Reg. § 1.537-1(a) (1968).

30. *E.g.*, Bardahl Mfg. Corp., 24 CCH Tax Ct. Mem. 1030 (1965). *See also* Apollo Indus., Inc. v. Commissioner, 358 F.2d 867, 876 (1st Cir. 1966); Bardahl Int'l Corp., 25 CCH Tax Ct. Mem. 935 (1966).

31. An operating cycle is the period of time required to convert cash into raw materials, raw materials into inventory as marketable products, inventory into sales, sales into accounts receivable, and accounts receivable into cash.

32. Such activities as expansion into new areas or the building of new facilities do not occur so frequently that a small corporation will be able to make a prediction on the basis of

"definite plan" of development. If such needs are infrequent, projected planning may prove difficult and the amounts retained excessive. The problem of establishing the existence of a definite plan may present difficulties in view of the subjective nature of the test applied.[33] What seems definite to the man closely associated with the project may seem vague to the Commissioner, and, regardless of what happens in the courts, this problem supplies a means of coercing the taxpayer to settle other matters.[34] If the plan cannot be adequately established, then the accumulation is subject to the penalty tax. The Regulations are barren of adequate guidelines concerning the accumulated earnings provisions of the Code. Considering that more than two per cent of the tax cases docketed last year dealt with these provisions,[35] it would seem incumbent upon the Commissioner to promulgate definite criteria for judging potential liability under these sections.

---

past needs. Most businessmen would probably be inclined to accumulate more than they thought absolutely necessary as a cushion against unforeseen problems.

33. Something more than a mere statement of intent is necessary in order to create a definite plan satisfactory to the Commissioner. Smoot Sand & Gravel Corp. v. Commissioner, 241 F.2d 197 (4th Cir. 1957); Ted Bates & Co., ¶ 65,251 P-H Tax Ct. Mem. 1476 (1965). Such intent may be evidenced by corporate minutes and documents, architectural drawings, and correspondence made during negotiations. Levitan, *Defensive Planning to Avoid the 531 Tax—Some Techniques to Use*, 26 J. TAX. 88, 89 (1967).

Intent is to be determined as of the time the decision to accumulate is made. Harry A. Koch Co. v. Vinal, 228 F. Supp. 782, 786 (D. Neb. 1964); Treas. Reg. §§ 1.537-2(b), (c) (1959). It is generally conceded that decisions of corporate managers are entitled to great weight when determining the need to accumulate, Hardin's Bakeries, Inc. v. Martin (S.D. Miss. 1967), *cited in* 19 Am. Fed. Tax R.2d 647, 649 (1967), and should not be subject to second-guesses by the Commissioner. R. Gsell & Co. v. Commissioner, 294 F.2d 321, 326 (2d Cir. 1961); James M. Pierce Corp., 38 T.C. 643 (1962), *rev'd on other grounds*, 326 F.2d 67 (8th Cir. 1964); Breitfeller Sales, Inc., 28 T.C. 1164 (1957). However, hindsight may be applied by the courts to determine whether there ever existed an intent to consummate plans for which accumulations were made. Where such plans are actually carried out, hindsight benefits those corporations whose plans were somewhat vague or indefinite. *See e.g.*, Dahlem Foundation, Inc. v. United States (6th Cir. 1968), *cited in* 22 Am. Fed. Tax R.2d 5962 (1968) (corporate minutes showed that real estate development company continually sought property to purchase); Bremerton Sun Publishing Co., 44 T.C. 566 (1965) (although petitioner had no definite plan at time of accumulation it had a history of constant growth). Courts seem to place more reliance on their own subjective determination of good faith than upon any objective standard.

34. *See* note 26 *supra*.

35. Tretheway, *Effective Use of Statistical Analysis to Fend Off 531 Attack*, 30 J. TAX. 80 (1969).

## Taxation—Corporate Reorganizations—Merger of Mnltiple Corporate Entities May Constitute an F Reorganization

Bernard H. Stauffer was the sole owner of three corporations located in California, Illinois, and New York.[1] In 1958 the Stauffer operations were moved to New Mexico and the three corporations were merged into one.[2] There was no change in the business operations or the ownership of the business.[3] In 1960 the new corporation, Stauffer New Mexico, suffered a severe net operating loss which it sought to carry back against the pre-merger income of the transferor corporations. Stauffer New Mexico's application for refund of taxes paid by Stauffer California for 1958 and 1959 was approved.[4] In 1963 the Commissioner assessed deficiencies against the three constituent corporations, claiming that the corporate loss carryback is allowed only to corporations qualifying under section 368(a)(1)(F)[5] and that this section does not apply when more than one corporation is involved; consequently, the losses of a surviving corporation can only be carried back against the pre-merger income of the same corporation. The taxpayer contended that the merger qualified as an F reorganization and therefore such a loss carryback was proper under section 381(b) of the Internal Revenue Code.[6] The Tax Court held that an F reorganization is limited to the

1. All three corporations were engaged in the sale of weight reducing apparatus manufactured by the California and Illinois corporations. The officers and directors were the same for all three corporations. All board meetings were held at the home office of Stauffer California in Los Angeles, where the books for the three corporations were kept.

2. The merger, ruled by the Internal Revenue Service to constitute a "statutory" merger within the terms of § 368(a)(1)(A) of the Internal Revenue Code, was consummated on October 1, 1959, by the filing of the merger agreement with the Secretary of State in each of the four affected states.

3. The merger agreement provided that the stated capital, paid-in surplus, and retained earnings of the newly-formed corporation were to equal the sums of the respective items of the three transferor corporations. All property of the transferor corporations was to be vested in Stauffer New Mexico. The liabilities and obligations of the transferors were to be assumed by the New Mexico corporation. Stauffer New Mexico also assumed the accounting procedures of the three constituent corporations without change, as each of the three reported its income on the fiscal year February 1 – January 31.

4. Section 6411(b) of the Internal Revenue Code authorizes the Secretary or his delegate to make such a refund, known as the "quickie" refund, to the taxpayer within 90 days after his application therefor.

5. An F reorganization is defined by § 368(a)(1)(F) of the Internal Revenue Code as a "mere change in identity, form, or place of organization, however effected."

6. Section 381(b)(3) of the Internal Revenue Code provides: "[E]xcept in the case of an acquisition in connection with a reorganization described in subparagraph (F) of section 368(a)(1) - [t]he corporation acquiring property in a distribution or transfer . . . [involving the

reorganization of a single corporation.[7] On appeal to the Ninth Circuit Court of Appeals, *held*, reversed. The merger of multiple corporate entities can constitute an F reorganization when the proprietary interest in the transferors and transferee is identical and there is no interruption of business continuity. *Estate of Stauffer v. Commissioner*, 403 F.2d 611 (9th Cir. 1968).[8]

The F reorganization first appeared in the Revenue Act of 1921. Section 202(c)(2) of that act included in the definition of corporate reorganization a "mere change in identity, form, or place of organization of a corporation (however effected)." This definition was reenacted in identical language in the Revenue Act of 1924 except for the deletion of the words "of a corporation."[9] The few early cases applying the F reorganization provision,[10] while not defining its scope, did establish one important requirement for its application—continuity of ownership of the proprietary interest in the corporation. The F reorganization was carried over into the 1954 Code, and in the late 1950's the Commissioner issued two very significant rulings dealing

acquisition of assets of a corporation by another corporation] . . . shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation." Treasury Regulation § 1.381(b)-1(a)(2) clarifies this section of the Code by providing that: "[I]n the case of a reorganization qualifying under section 368(a)(1)(F) . . . the acquiring corporation shall be treated (for the purposes of section 381) just as the transferor corporation would have been treated if there had been no reorganization. . . . [A] net operating loss of the acquiring corporation for any taxable year ending after the date of transfer shall be carried back in accordance with section 172(b) in computing the taxable income of the transferor corporation for a taxable year ending before the date of transfer."

7. Estate of Bernard H. Stauffer, 48 T.C. 277 (1967)

8. The Internal Revenue Service recently announced that it will not follow this decision. Rev. Rul. 69-185, 1969 INT. REV. BULL. No. 16, at 11.

9. This deletion seems to reflect merely a draftsman's preference in eliminating the words as surplusage. The House Ways and Means Committee explained the omission as a "minor change in phraseology." H.R. REP. NO. 179, 68th Cong., 1st Sess. 13 (1923).

10. The first case to consider the then equivalent of the F reorganization was Ahles Realty Corp. v. Commissioner, 71 F.2d 150 (2d Cir. 1934), wherein a corporation transferred all its assets to a new corporate entity in exchange for stock and bonds of the new corporation. The old corporation then distributed these securities to its sole shareholder and thereafter dissolved. The court held the transaction to be "a mere change of identity, form, or place of organization," *id.* at 151, because there was a complete continuity of interest as to the assets of the new corporation and its ownership, the sole stockholder of the old corporation becoming the sole stockholder of the new and retaining his 100% interest in identical assets. In 1942 the Supreme Court refused to find "a mere change of identity, form, or place of organization" where, pursuant to a plan by which an insolvent corporation was foreclosed and transferred its properties to a new corporation in exchange for the latter's common stock and stock purchase warrants, the participating creditors of the old corporation received the rights to receive over a majority of the stock of the new company, thus leaving the stockholders of the new corporation with less than half the ownership of the proprietary interest they had enjoyed in the old corporation. Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1942).

with the subject.[11] In both situations, even though the reorganizations would have qualified as statutory mergers under section 368(a)(1)(A), the Service ruled that if the reorganization met the requirements of section 368(a)(1)(F), it would also be an F reorganization. In Revenue Ruling 56-276 the Service ruled that an F reorganization will be held to be such even if it qualifies under one or more of the other section 368(a)(1) reorganization definitions. In Revenue Ruling 58-422, involving a parent and two subsidiary corporations, the Service ruled that an A reorganization could also qualify as an F reorganization, but the Service restricted its ruling to the parent only. In both rulings the Internal Revenue Service was careful to apply the loss carryback only to a single corporate entity, or, in the case of a parent-subsidiary group, only if prior to the merger consolidated income tax returns had been filed. The Commissioner also adopted the view of the courts in the early cases that the F reorganization definition applies to all cases where there is complete continuity of interest as to the assets of the corporation and its ownership.[12]

Despite its long history as part of the internal revenue laws, there was relatively little activity with regard to the F reorganization until the 1960's, when several cases were decided which involved the application of section 368(a)(1)(F) to a liquidation-reincorporation situation. In 1962 in *Joseph C. Gallagher*[13] the Tax Court held that a 38 per cent change in the shareholder's proprietary interest would disqualify a reorganization from the section 368(a)(1)(F) definition. In 1966 the Tax Court and the Second Circuit Court of Appeals held that a "substantial" change in ownership disqualifies the transaction as an F reorganization.[14] However, the issue as to how substantial a change in ownership is needed to disqualify a reorganization from the section 368(a)(1)(F) definition is still very much in doubt, especially in light of the Fifth Circuit's holding in *Reef Corp. v. Commissioner*[15] that a 48 per cent shift in proprietary interest does *not* disqualify the reorganization under section

11. Rev. Rul. 57-276, 1957-1 CUM. BULL. 126; Rev. Rul. 58-422, 1958-2 CUM. BULL. 145.

12. Rev. Rul. 58-422, 1958-2 CUM. BULL. 145, 146. *See also* Treas. Reg. § 1.1002-1(c) (1957).

13. 39 T.C. 144 (1962). *See also* Rev. Rul. 61-156, 1941-2 CUM. BULL. 62, holding that a 45% change in stock ownership will not disqualify F reorganization treatment, where the transaction satisfies the requirements of both D and F reorganizations.

14. Hyman H. Berghash, 43 T.C. 743 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966) (50% change in proprietary interest sufficient to disqualify a reorganization under § 368(a)(1)(F)).

15. 368 F.2d 125 (5th Cir. 1966).

368(a)(1)(F). The facts in *Reef* also qualified the transaction as a D reorganization, but the court held that where a reorganization meets the requirements of both sections 368(a)(1)(D) and (F), it should be construed as an F reorganization. In *Davant v. Commissioner*[16] the Fifth Circuit recently adopted the approach of Revenue Ruling 61-156,[17] finding both a D and an F reorganization. The court found an F reorganization on the theory that section 368(a)(1)(F) was intended to apply to changes in form, as opposed to changes in substance, where the corporate enterprise continues uninterrupted and there is a complete identify of shareholders and their proprietary interests. The *Davant* opinion uses the term "alter ego" to refer to the transferee corporation, indicating that where the transferee is the "alter ego" of the transferor, a Type F reorganization results. The Fourth Circuit, in *Pridemark, Inc. v. Commissioner,*[18] also used the term "alter ego" in limiting the application of section 368(a)(1)(F) to cases where the corporate enterprise continues uninterrupted, there being but a change in corporate vehicles. Thus the case law has dealt with the question of what will qualify as "a mere change in identity, form, or place of organization." There is no case law dealing with the significance of 368(a)(1)(F) when considered in light of section 381(b)(3),[19] providing for the carryback of a net operating loss occuring after the reorganization.[20]

Looking first to the question of whether the Stauffer merger qualified as an F reorganization, the instant court, relying principally upon the Fifth Circuit's decision in *Davant v. Commissioner,*[21] found two factors necessary to constitute an F reorganization: first, the reincorporation involved no change in the proprietary interest of the stockholder; and second, the business enterprise of the transferor

---

16. 366 F.2d 874 (5th Cir. 1966). In *Davant* two active brother-sister corporations were reorganized into one. Each corporation was engaged in a separate business and was merged without change in ownership, but with a $900,000 cash distribution to the shareholders. The Tax Court found only a D reorganization. The appellate court approved this finding but went on to find an F reorganization as well, thus preventing the corporation's liquidation transaction, taxable as ordinary dividend income, from disguising itself as a capital gains distribution.

17. See note 13 *supra* and accompanying text.

18. 345 F.2d 35 (4th Cir. 1965). One ground upon which the Fourth Circuit reversed the Tax Court's finding of an F reorganization was the length of time (one year) between liquidation and reincorporation.

19. Revenue Rulings 57-276 and 58-422 provide the only legal precedent for the definition of an F reorganization for purposes of section 381(b). See note 11 *supra* and accompanying text.

20. See note 6 *supra*.

21. 366 F.2d 874 (5th Cir. 1966). See note 16 *supra* and accompanying text.

corporations continued unimpaired.[22] To further bolster its finding of an F reorganization, the court emphasized that the sword of section 368(a)(1)(F) cuts both ways. Thus, the court reasoned, the Commissioner cannot vary his position as to what constitutes an F reorganization depending upon whether the issue is the treatment of capital gain, as in *Davant*,[23] or loss carryback, as in the instant case. The court determined that the definitive principles of an F reorganization cannot vary with the position the Commissioner prefers. The majority concluded that the reorganization in the instant case involved a mere change in form, not a change in the substance of the transferor corporations, and thus the acquiring corporation became the "alter ego" of the transferors, resulting in an F reorganization.

Turning its attention to the question of whether a loss carryback should be allowed under section 381(b),[24] the court implied that Congress's failure to except the F reorganization from the multi-corporate provisions in section 381(c)(1)(A)[25] indicated an absence of any congressional intent to limit the F reorganization to a single corporation.[26] The court found that Stauffer New Mexico's having had no pre-merger taxable year to which any loss could have been carried back constituted further evidence that it stood in the shoes of the pre-merger transferor corporations. The court found merit in the taxpayer's argument that had the merger taken any one of a number of other forms, there could have been a loss carryback to one of the predecessor corporations.[27] The instant court concluded

22. "In the instant case, the only change that took place was that Stauffer New Mexico reported the combined income of the three pre-merger corporations in one tax return; the individual books of the constituent enterprises were kept as they had been before the merger; the enterprises continued to operate in the same manner and at the same location as before the merger; the change was one of corporate vehicles only." 403 F.2d at 619.

23. See note 16 *supra* and accompanying text.

24. See note 6 *supra*.

25. INT. REV. CODE of 1954, § 381(c)(1)(A) provides: "The net operating loss carryovers determined under section 172 [are] subject to the following conditions and limitations: (A) The taxable year of the acquiring corporation to which the net operating loss carryovers of the distributor or transferor corporation are first carried shall be the first taxable year ending after the date of distribution or transfer."

26. The court here assumes that the inverse of § 381(c)(1)(A) is a correct statement of the law: namely that § 381(c)(1)(A), which does not exempt the F reorganization, would prevent a carryback of a net operating loss of the transferor corporations to a pre-merger taxable year of the transferee.

27. For example, if Stauffer Illinois and Stauffer New York had merged into Stauffer California, the latter could have carried back a post-merger loss to one of its own pre-merger taxable years under Treasury Regulation § 1.381(c)(1)-1(b) (1960). Likewise if Stauffer

that section 381(b) permits a loss sustained by the transferee corporation after a corporate reorganization to be carried back to a pre-merger taxable year of one of three transferor corporations. Finally, the court addressed itself to the problem of determining the extent of loss which Stauffer New Mexico was entitled to carry back and to which of the three pre-merger corporations the loss could be carried. After first pointing out that tax avoidance was not involved, the court drew an analogy to the "but for" approach in *Libson Shops, Inc. v. Koehler*,[28] stating that "[*b*]*ut for* the simultaneous merger of the three corporations, the loss carryback would have been undeniably allowed."[29] Therefore, the court concluded that the portion of the losses sustained by Stauffer New Mexico attributable to the operations of Stauffer California could be carried back to the California corporation, but not to the Illinois and New York corporations. The court admitted that this loss carryback would have created problems had the three operations been physically combined, but pointed out that this was merely a problem of tax accounting which could not change the conclusion that the transaction in the instant case was an F reorganization.

Since section 368(a)(1)(F) is a definitional section, it is inoperative in and of itself, taking significance only when considered in light of other sections of the Code, in this case section 381(b).[30] The critical question is whether section 368(a)(1)(F) can apply to the reorganization of more than one corporation for the purposes of section 381(b). The House version of section 381 originally denied a loss carryback in all cases,[31] but the Senate proposed the allowance of a carryback in exchanges involving mere changes of identify, form, or *place of organization*.[32] It has been held that the F reorganization was intended to comprehend "only such insignificant modifications as the reincorporation of the same corporate business . . . under a new charter either in the same or a different State, [or] the renewal of a

---

California had reincorporated into Stauffer New Mexico, then Stauffer Illinois and Stauffer New York merged into Stauffer New Mexico, a loss sustained by Stauffer New Mexico could have been carried back against the pre-merger Stauffer California income under the above regulation. 403 F.2d at 619.

28. 353 U.S. 382 (1957). The Court in *Libson Shops* stated that "had there been no merger, these businesses would have had no opportunity to carry over their losses." *Id.* at 388.

29. 403 F.2d at 621. See note 27 *supra*.

30. *See* note 6 *supra*.

31. H.R. REP. No. 1337, 83d Cong., 2d Sess. A135 (1954).

32. S. REP. No. 1662, 83d Cong., 2d Sess. 273 (1954) (emphasis added).

corporate charter having a limited life."[33] Thus it appears that the legislative purpose in excepting the F reorganization from the loss carryback provisions of section 381(b) was to prevent unfairness through denial of a loss carryback to a corporation that was essentially the same entity for tax purposes that existed prior to the reorganization. Yet in the instant case it can hardly be argued that Stauffer New Mexico was for tax purposes the same corporate entity that existed prior to the merger. Although ignored by the Ninth Circuit, the Tax Court pointed out that the taxpayer's three transferor corporations took multiple surtax exemptions. The taxpayer also had the advantage of three 100,000 dollar accumulated earnings tax credits. The new corporation would only be allowed one such exemption and credit. In *Libson Shops* the Supreme Court distinguished the typical F reorganization situation of the reincorporation of a single corporation in another jurisdiction from the multiple corporate merger situation before it on the ground that the multiple reincorporation involved the combination of several businesses which, until the time of the merger, had been taxed as separate entities. In the words of the Court, "this difference is not merely a matter of form."[34]

Other significant changes occurred as a result of the reorganization which cannot be characterized as "mere changes in form." Prior to the merger only Stauffer California and Stauffer Illinois manufactured the Stauffer products. Stauffer New York purchased its needs from the other two and engaged only in selling and leasing activities. There were undisclosed amounts of buying and selling between Stauffer California and Stauffer Illinois. After the merger a creditor of any one of the three transferor corporations could look to the combined assets of the new corporation to satisfy its claim, since the capital and surplus accounts of the constituent corporations were combined. Although the instant court stated that the problems arising from the intermingling of two businesses are merely problems of accounting, the possible consequences of the merger of two loss corporations and one profit corporation should be obvious. Further, a loss occurring during the taxable year after the merger gives rise to allocation difficulties in the carryback. These problems would seem more serious than mere questions of accounting practice.

33. Hyman H. Berghash, 43 T.C. 743, 752 (1965), *aff'd*, 361 F.2d 257 (2d Cir. 1966).

34. 353 U.S. at 388.

There are other problems, here to be only mentioned, which tend to cast doubt on the wisdom of the instant decision, given the great administrative difficulties that can be foreseen. The first of these involves section 1244 of the Internal Revenue Code.[35] When several predecessor corporations are allowed to qualify under section 368(a)(1)(F), it is difficult to determine which prececessor, or whether all the predecessors taken together, may be taken into account in determining whether the complex requirements of subsections (c)(1)(E) and (c)(2)(A) of section 1244 have been satisfied. Second, the instant court's holding that an F reorganization need not be limited to a single corporation poses difficulties in that a deficit in one corporation would presumably offset surplus in another, thus affecting future dividends that might be paid by the new entity. Third, it appears that the advantages to the taxpayer as a result of the instant decision are limited. The court's holding applies to the reorganization of multiple entities where the proprietary interest of the transferors and the transferee is "identical." Thus, even in the Ninth Circuit the taxpayer will be permitted to carry the transferee corporation's post-merger loss back to the pre-merger income of one of the transferor corporations only where all the transferor corporations are owned by the same shareholders with identical proprietary interests in each. It is indeed unlikely that this factual situation will occur frequently.

In the instant case it appears that only by disregarding the pre-merger corporate entities[36] and treating them as multiple corporations carrying on a single business can it be said that there was merely that type of purely formal change which characterizes an F reorganization. But, as has been demonstrated, this was simply not the case. Here three separate surtax exemptions were taken prior to the merger, one for each corporation. The three corporations constituted separate entities, each conducting its own business, and were treated as separate for all purposes, including the computation of taxes. Thus it is submitted that labeling the unification of three separate corporations an F reorganization is tantamount to amending section 381(b) to read:

Except in the case of an acquisition in connection with a reorganization

35. Section 1244 provides in general that losses on common stock of a "small business corporation" may be deducted as ordinary losses instead of losses from the sale or exchange of a capital asset.

36. The courts have been reluctant to disregard corporate entities. *See, e.g.*, Commissioner v. Laughton, 113 F.2d 103 (9th Cir. 1940). *See generally* Sanford H. Hartman, 43 T.C. 105 (1964).

> described in subparagraph (F) of section 368(a)(1), *and except when such reorganization involves a merger or consolidation of multiple corporate entities* . . .
> (3) The corporation acquiring property in a distribution or transfer described in subsection (a) shall not be entitled to carry back a net operating loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation.

Certainly Congress never contemplated the reorganization of multiple corporate entities when it enacted section 381(b) of the Internal Revenue Code of 1954.

## Taxation—Federal Estate Tax—Cotrusteeship Sufficient Incident of Ownership To Reqnire Inclusion of Corpus in Cotrnstee's Gross Estate Where Possibility of Economic Benefit Exists

Decedent's wife, Vera Berns Fruehauf, paid all the premiums on several insurance policies written on the life of decedent,[1] naming herself as beneficiary[2] and sole owner of the policies. Mrs. Fruehauf pre-deceased decedent by fourteen months. Under the provisions of her will, decedent was named coexecutor of her estate, the recipient of all her personal property, and cotrustee and life beneficiary of two trusts containing the balance of her estate.[3] The trustees were given broad powers to retain the life insurance policies as long as they so desired, to assign some of the policies to obtain money to pay premiums, to designate decedent as a beneficiary, and to sell or convert the policies for their cash surrender value.[4] At the time of decedent's death, there had been no distribution to the trusts as

1. Mrs. Fruehauf had acquired six insurance policies upon her husband's life, with a total face value of $210,000.

2. Mrs. Fruehauf subsequently altered the beneficiary designation on each of the six policies wherein she was made the primary beneficiary and her son, Harry R. Fruehauf, Jr., was made secondary beneficiary in the case of her death.

3. Mrs. Fruehauf provided in her will that the executors of her estate and the trustees of the two trusts to be established were to be her husband, Harry R. Fruehauf, Howard B. Knaggs, and the Detroit Bank and Trust Company. It should be noted that the two alternates Mrs. Fruehauf authorized - Harry R. Fruehauf, Jr., and Thomas L. Munson- subsequently became executors of the estate of Harry R. Fruehauf, along with the Detroit Bank and Trust Company, all petitioners herein.

4. The powers of the trustees were stated broadly in Mrs. Fruehauf's will: "[I]n addition to the powers and authorities elsewhere granted in this Will, I empower the trustees of each of the trusts created hereunder to do everything they deem advisable even though it would not be authorized or appropriate for fiduciaries (but for this power) under any statutory or other rule of law."

provided by Mrs. Fruehauf's will, and the corpus was then distributed to decedent's son, as remainderman. The executors of decedent's estate did not include the proceeds of the insurance policies in his estate tax return, basing their exclusion on the belief that the "incidents of ownership" necessary for inclusion within the gross estate should be limited to the right of decedent or his estate to receive the economic benefits of the policies.[5] The Commissioner asserted a deficiency for the proceeds of the insurance policies,[6] claiming that decedent, at the time of his death, possessed sufficient incidents of ownership, either alone or in conjunction with others, to include the policies in his gross estate under section 2042 of the Internal Revenue Code.[7] On determination by the Tax Court, *held*, for the Commissioner. The proceeds of policies of insurance written on the life of a decedent and purchased by another, but over which decedent later assumes incidents of ownership as cotrustee, are includible within his gross estate under section 2042 of the Internal Revenue Code, regardless of the capacity in which such incidents of ownership are exercised. *Estate of Harry R. Fruehauf*, 50 T.C. 915 (1968).

Under section 2042,[8] the proceeds of any life insurance written on the life of a decedent and payable to other beneficiaries are includible in an insured's gross estate to the extent to which he possessed at his death any of the incidents of ownership over the policies, exercisable either alone or in conjunction with any other person. It has been held that neither complete legal and equitable title to the policies of insurance[9] nor their physical possession[10] is necessary to establish incidents of ownership for inclusion in a decedent's gross estate. Incidents of ownership have been found to be present when an insured

5. The petitioner's contention is based upon Treas. Reg. § 20.2042-1(c)(2) (1958): "[T]he term 'incidents of ownership' is not limited in its meaning to ownership of the policy in the technical legal sense. Generally speaking, the term had reference to the right of the insured or his estate to the economic benefits of the policy."

6. The Commissioner determined the deficiency in the estate tax on decedent's estate to be $75,462.68.

7. INT. REV. CODE OF 1954, § 2042(2): "The value of the gross estate shall include the value of all property—. . . (2) RECEIVABLE BY OTHER BENEFICIARIES.—To the extent of the amount receivable by all other beneficiaries as insurance under policies on the life of the decedent with respect to which the decedent possessed at his death any of the incidents of ownership, exercisable alone or in conjunction with any other person."

8. *Id.*

9. United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 10 (1st Cir. 1966).

10. Commissioner v. Noel, 380 U.S. 678 (1965); Estate of Piggott v. Commissioner, 340 F.2d 829 (6th Cir. 1965); Godfrey v. Smyth, 180 F.2d 220 (9th Cir. 1950); Hall v. Wheeler, 174 F. Supp. 418 (D.Me. 1959).

possessed at the time of his death these powers: to alter the beneficiaries under a policy,[11] to surrender or cancel the policy,[12] to borrow from the insurer against the surrender value of the policy,[13] or to assign the policy.[14] In determining incidents of ownership, there is, however, a lack of unaniminity in the decisions dealing with the capacity under which these powers are exercisable. The Tax Court originally found that a limitation on the power of the decedent to act only within the capacity of a trustee was immaterial.[15] This decision was subsequently extended to hold that regardless of the actual establishment of the trust, powers granted to a trustee in a trust instrument must be considered to have been held by him as long as he had the power to become a trustee at the time of his death.[16] Similarly, the First Circuit held, in *United States v. Rhode Island Hospital Trust Co.*,[17] that the phrase "incidents of ownership" connoted something partial, minor, or even fractional in scope and spoke more in terms of possibility than of probability.[18] This language indicated that perhaps any capacity of an insured to control the incidents of ownership, even though this control might be exercised in the capacity of a trustee, would be sufficient to include the proceeds of the insurance in the insured's gross estate under section 2042.[19] The Second Circuit, however, took a different view of a decedent's capacity in *Estate of Newcomb Carlton*.[20] In *Carlton*, the decedent created an inter vivos trust to which he conveyed certain securities and

---

11. *E.g.*, Commissioner v. Noel, 380 U.S. 678 (1965); Fernandez v. Wiener, 326 U.S. 340 (1945); Estate of Piggott v. Commissioner, 340 F.2d 829 (6th Cir. 1965); Commissioner v. Estate of Karagheusian, 233 F.2d 197 (2d Cir. 1956); Fried v. Granger, 202 F.2d 150 (3d Cir. 1953); Singer v. Shaughnessy, 198 F.2d 178 (2d Cir. 1952).

12. *E.g.*, Commissioner v. Treganowan, 183 F.2d 288 (2d Cir.), *cert. denied sub nom.* Estate of Strauss v. Commissioner, 340 U.S. 853 (1950); Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945); Ballinger v. Commissioner, 23 B.T.A. 1312 (1931).

13. *E.g.*, Fried v. Granger, 202 F.2d 150 (3d Cir. 1953); Liebmann v. Hassett, 148 F.2d 247 (1st Cir. 1945); Walker v. United States, 83 F.2d 103 (8th Cir. 1936).

14. Commissioner v. Noel, 380 U.S. 678 (1965).

15. Estate of Albert Nettleton, 4 T.C. 987, 991 (1945). *See generally* Van Beuren v. McLoughlin, 262 F.2d 315 (1st Cir. 1958), *cert. denied*, 359 U.S. 991 (1959); Estate of Loughridge v. Commissioner, 183 F.2d 294 (10th Cir.), *cert. denied*, 340 U.S. 830 (1950); Union Trust Co. v. Driscoll, 138 F.2d 152 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1944); Estate of John Moir, 47 B.T.A. 765 (1942); Daniel J. Gallery, 38 B.T.A. 1211 (1938).

16. Estate of Ralph Budd, 49 T.C. 468 (1968).

17. 355 F.2d 7 (1st Cir. 1966).

18. *Id.* at 10.

19. Authority for this characterization of minimal powers, or powers held in differing capacities as "incidents of ownership" could be derived by analogy from the language of § 2038. *See* note 27 *infra*, and accompanying text.

20. 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962).

life insurance policies written on his life. There the court found that decedent did not possess incidents of ownership at his death, even though under the trust he retained the right to receive income in excess of that needed to pay the premiums, as well as the right to appoint himself as cotrustee.[21] This decision was supplemented by the Tax Court in *Estate of Bert L. Fuchs*,[22] which held that the naked power of a trustee to affect trust proceeds was insufficient to bring insurance proceeds within decedent's gross estate.[23]

In the instant case, the Tax Court noted that the fact that there had been no distribution of proceeds into the trusts of which decedent was to be cotrustee prior to his death was immaterial to the determination of whether or not the incidents of ownership were sufficient to include the proceeds of the insurance in the insured decedent's gross estate.[24] The court determined that "[t]he material fact is the existence of powers without regard to decedent's ability to exercise them at a particular moment."[25] The court also rejected

21. In holding that decedent did not possess incidents of ownership at his death, the Tax Court stated: "Any control that decedent would have acquired over the insurance policies had he appointed himself cotrustee would have been control over the policies jointly with the corporate trustee as trustee only and such control would be solely for the benefit of the trust. Such control as trustee would not constitute incidents of ownership in the insurance policies in decedent except in his capacity as trustee for the benefit of the trust." 34 T.C. at 996. It should also be noted that the obligations imposed on and rights granted to the trustees with respect to the policies of insurance were strikingly similar to those in the instant case. *See id.* at 989-90.

22. 47 T.C. 199 (1966).

23. In *Fuchs*, the Tax Court stated: "The partners' agreement with respect to the . . . policies created an informal relationship of a quasi-trust nature which obligated the partners to deal with each policy in a manner conforming to the terms of the agreement. Assuming. *arguendo*, that the insured of each policy herein possessed the naked power to change beneficiaries or make an assignment, we cannot say, in view of the partners' agreement regarding the policies, that the insured herein should be treated in any way differently than a common trustee. Each insured herein was under no less of a legal duty to respect the terms of the partners' agreement than a common trustee legally obligated to respect the terms of a trust indenture. Decedent merely had the same type of power over the . . . policies as a trustee's power to affect trust proceeds. We do not believe that this kind of naked power alone is sufficient to bring the insurance proceeds within decedent's gross estate." 47 T.C. at 204, *acquiesced in*, 1967-1 CUM. BULL. 2.

24. 50 T.C. at 921.

25. *Id.* The Court here based its argument upon the holding of Commissioner v. Noel, 380 U.S. 678, 684 (1965), which stated: "It would stretch the imagination to think that Congress intended to measure estate tax liability by an individual's fluctuating, day-by-day, hour-by-hour capacity to dispose of property which he owns. We hold that estate tax liability for policies 'with respect to which the decedent possessed at his death any of the incidents of ownership' depends on a general, legal power to exercise ownership, without regard to the owner's ability to exercise it at a particular moment." The Tax Court had also previously held in Estate of Powel Crosley, Jr., 47 T.C. 310 (1966), that "respondent [Commissioner] construes the failure of the trustees to exercise all incidents of ownership as meaning that those incidents did not actually pass to the trustees, but

petitioner's assertion that powers held in a fiduciary capacity were not incidents of ownership. Analogizing the purpose of section 2042[26] to that of section 2038[27] of the Internal Revenue Code, the court reasoned that although decedent could only exercise power as cotrustee, this could not alter the conclusion that the decisive factor in determining incidents of ownership was the *scope* of decedent's power, regardless of the capacity in which that power could be exercised.[28] The court reasoned that frustration of both Code sections with tax avoidance would result if applicability depended upon insubstantial alterations made in the title given to decedent, rather than the powers conferred upon him.[29] The court further concluded that the fact that a trustee owed a duty of faithful administration for which he could be made to answer in an action at law or in equity should in no way limit a determination that incidents of ownership were present.[30] The court concluded its analysis of incidents of ownership by holding that Congress intended sections 2038 and 2042 of the Code to be portions of a general tax pattern, subjecting property over which decedent maintained power of enjoyment to inclusion within his gross estate. Since capacity is irrelevant under section 2038,[31] no logical reason exists which would require a determination of the scope of capacity to be made in cases decided under section 2042. Therefore, since decedent possessed broad powers, either individually or as cotrustee, to dispose

remained in Crosley [decedent]. Neither the failure to exercise ownership nor even a momentary or temporary inability to exercise it matters. It is only important whether or not decedent possessed at his death any of the incidents of such ownership in a general, legal sense." *Id.* at 320.

26. INT. REV. CODE OF 1954, § 2042(2). See note 7 *supra* for the text of § 2042(2).

27. INT. REV. CODE OF 1954, § 2038(a)(1): "The value of the gross estate shall include the value of all property—To the extent of any interest therein of which the decedent has at any time made a transfer (except in case of a bona fide sale for an adequate and full consideration in money or money's worth), by trust or otherwise, where the enjoyment thereof was subject at the date of his death to any change through the exercise of a power (in whatever capacity exercisable) by the decedent alone or by the decedent in conjunction with any other person (without regard to when or from what source the decedent acquired such power), to alter, amend, revoke, or terminate, or where any such power is relinquished in contemplation of decedent's death."

28. *See, e.g.*, Union Trust Co. v. Driscoll, 138 F.2d 152, 154 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1944); Welch v. Terhune, 126 F.2d 695, 696 (1st Cir. 1942); Estate of John Moir, 47 B.T.A. 765, 772 (1942). It should be noted that these cases were decided under Int. Rev. Code of 1939, ch. 3, § 811(d), 53 Stat. 121, and the Revenue Act of Feb. 26, 1926, ch. 27, § 302(d), 44 Stat. 70, both predecessors to INT. REV. CODE OF 1954, § 2038.

29. The Tax Court here follows the logic of Union Trust Co. v. Driscoll, 138 F.2d 152, 154 (3d Cir. 1943), *cert. denied*, 321 U.S. 764 (1944).

30. *See* Reinecke v. Smith, 289 U.S. 172, 177-78 (1933); United States v. Rhode Island Hosp. Trust Co., 355 F.2d 7, 11 (1st Cir. 1966).

31. 50 T.C. at 926. See also notes 19 & 27 *supra*, and accompanying text.

of any or all of the proceeds of the insurance policies,[32] their inclusion within his gross estate at the time of his death was appropriate.

The Tax Court in the instant case has firmly committed itself to a position contrary to that taken by the Second Circuit in *Carlton*.[33] The instant opinion suffers, however, in merely restating the arguments considered in *Carlton* and avoiding a comparative analysis. A major reason for the dilemma in the instant case is that neither the Internal Revenue Code, nor the regulations, nor previous court decisions give a comprehensive definition of incidents of ownership when used in conjunction with powers which may only be utilized in the capacity of trustee. The taxpayer is thus placed in the often perilous position of determining the extent to which he may function as a trustee without incurring the risk of inclusion of the trust corpus within his gross estate upon death. Occasionally such a decision is required, as in *United States v. Rhode Island Hospital Trust Co.*,[34] where the court found sufficient incidents of ownership in the terms of the policy.[35] The instant court's reliance on that case would seem misplaced, however, when it is recalled that whatever incidents of ownership exist are modified by the fiduciary capacity in which they are held, and are thus subject to the fiduciary restrictions of state law.[36] Furthermore, the court's insistence upon the immateriality of the capacity in which the incidents of ownership are held finds little support in the Code. Reasoning by analogy has its limits; merely because there are no definitive restrictions within section 2038 of the Internal Revenue Code, it does not necessarily follow that there should not be such restrictions within section 2042. Section 2038 does, after all, require that the decedent be a transferor of the property,[37] thus encompassing a different situation that that contemplated by section 2042. The possibility of harsh result upon the taxpayer is well

---

32. 50 T.C. at 926.

33. 34 T.C. 988 (1960), *rev'd on other grounds*, 298 F.2d 415 (2d Cir. 1962). *See* note 21 *supra*.

34. 355 F.2d 7 (1st Cir. 1966).

35. *Id.* at 8-9.

36. In Sloan v. Silberstein, 2 Mich. App. 660, 141 N.W.2d 332, (1966), a case in which the other beneficiaries of a trust brought action against a trustee who was also a beneficiary based upon breach of trust, the Michigan Court of Appeals stated: "In general, the trustee owes a duty of ordinary skill and diligence in the administration of the affairs of the trust, complete loyalty to the interest of *cestui que trust*, to show good faith and fair play in direct dealing with the beneficiaries of the trust, and at no time may he use or deal with trust property for his own profit or for any other purpose unconnected with the trust." 2 Mich. App. at 673, 141 N.W.2d at 338. *See also* Estate of Harry R. Fruehauf, 50 T.C. 915 (1968).

37. INT. REV. CODE OF 1954, § 2038(a)(1), *supra* note 27.

illustrated by the facts of the instant case, in that decedent is burdened with the insurance proceeds within his gross estate at death without ever having been placed in a position to reap the beneficial enjoyment of the proceeds. The instant case points up the need for careful redefinition of the scope and intent of incidents of ownership, a redefinition best promulgated by Congress.