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Recent Decisions

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RECENT DECISIONS

COMMODITY FUTURES TRADING COMMISSION ACT OF 1974—COMMODITY FUTURES TRADING COMMISSION REGULATIONS THAT RESTRICT DEALERS IN FOREIGN OPTIONS MORE SEVERELY THAN DEALERS IN FUTURES CONTRACTS ARE NOT ARBITRARY OR CAPRICIOUS

I. FACTS AND HOLDING

Plaintiffs, commodity option dealers[1] who trade in London options,[2] brought suit[3] to enjoin implementation of rules promulgated by the Commodity Futures Trading Commission[4] (Commission), under authority of the Commodity Futures Trading Commission Act,[5] to regulate the commodity options industry[6] in the United States. The dealers alleged that the rules were substantively and procedurally violative of the Administrative Procedure Act[7] (APA). Specifically, the plaintiffs challenged the regulations on five separate grounds: (1) that the regulations were adopted in violation of the APA in that they were published in final form only

1. The individual plaintiffs were: British American Commodity Options Corporation; Lloyd, Carr & Co.; Bristol Options, Inc.; Chartered Systems Corporation; Cleary Trading Company, Inc.; First New York Commodity Options, Inc. of Los Angeles; Williston Corporation and International Commodity Options, Ltd. An organization of dealers, the National Association of Commodity Options Dealers (NASCOD), also joined in the suit.

2. "London options" is a generic term used to describe options on commodity futures that are traded on various commodity exchanges in London. The most common of these are traded on the seven exchanges utilizing the International Commodity Clearing House (ICCH) and on the London Metals Exchange.

3. British American Commodity Options Corporation and Lloyd, Carr & Co. instituted proceedings in the Southern District of New York. NASCOD and the other plaintiffs initiated action in the District Court for the District of Columbia. The District of Columbia Court granted a change of venue, and Judge Knapp in New York granted a motion to consolidate the two actions.

4. Defendants in the action included William T. Bagley, Chairman of the Commission, the remainder of the Commissioners individually, and the Commission itself.

5. 7 U.S.C. §§ 1-22 (Supp. V 1975).

6. A "commodity future" is a contract to buy or sell a specific quantity of a commodity to be produced in the future. A "commodity option" is a contractual right to buy or sell a commodity future contract by some specific date at a specified price. *See* Long, *Commodity Options—Revisited*, 25 DRAKE L. REV. 75 (1975).

7. 5 U.S.C. §§ 551-59, 701-06, 1305, 3105, 3344, 5362, 7521 (Supp. V 1975).

fifteen days before most of them were to take effect;[8] (2) that the registration requirements of the rules[9] were arbitrary and capricious; (3) that the disclosure requirements of the regulations[10] were severe and punitive, thereby seriously hindering options dealers in their competition with dealers of futures contracts or stock options;[11] (4) that the minimum financial requirements applied to option dealers[12] were arbitrary, capricious, and unreasonable; and (5) that the requirement for option dealers to segregate ninety percent of a customer's money in a separate United States account[13] was arbitrary and unnecessary in that it duplicated protec-

8. 5 U.S.C. § 553(d) (1970) provides that "the required publication or service of a substantive rule shall be made not less than 30 days before its effective date, except . . . (3) as otherwise provided by the agency for good cause found and published with the rule."

9. 17 C.F.R. § 32.3 (1976). This section provides generally that, on or after Jan. 17, 1977, persons receiving money from an option customer as payment of the purchase price of an option must be registered with the Commission. Further, any person soliciting or accepting orders for options must be registered, it also being unlawful for any person so registered to operate in partnership with anyone not so registered.

10. 17 C.F.R. § 32.4 (1976). This section requires that each customer be furnished: a brief description of the option being offered; a notice of the duration of the option and the total quantity and quality of the commodity that may be purchased by exercise of the option; a complete breakdown of the purchase price into its constituent elements; a statement as to what type and degree of market movement is required for the customer to profit on the transaction; an explanation of the effect of foreign currency fluctuations on the transaction; and a boldface statement indicating the unsuitability of option contracts for many members of the public, including warnings that customers should be prepared to face total loss of the purchase price and that the Commission has not approved the specific option being offered.

11. British American indicated that its gross option premiums decreased from $2,238,748 in November to less than $1 million under the disclosure rules in December. British American Commodity Options Corp. v. Bagley, 552 F.2d 482, 491 (2d Cir. 1977), *cert. denied*, 46 U.S.L.W. 3306 (1977).

12. 17 C.F.R. § 1.17(b)(1) (1976). This section requires dealers in options to maintain a minimum working capital of $50,000. In contrast, § 1.17(a) requires a minimum working capital of only $10,000 for brokers dealing only in futures contracts.

13. 17 C.F.R. § 32.6 (1976). This section provides generally that the funds received from a customer must be segregated from the dealer's money in a separate account in the United States. A maximum of up to ten percent of the money received as the purchase price of the option is exempt from this requirement in order to enable the dealer to meet current operating costs. The dealers argue that this requirement in effect imposes a "double segregation" requirement because they are also required to forward the major part of the purchase price to London in order to secure the option position on the exchange there. 552 F.2d at 489.

tions already in force on the London Exchanges[14] and would force dealers out of business. The district court[15] enjoined implementation of the regulation requiring segregation of customer funds, holding that "plaintiffs have a reasonable likelihood of success in establishing that defendants acted arbitrarily and capriciously in imposing segregation requirements,"[16] but granted summary judgment for the defendants on all other challenges. On appeal to the Second Circuit Court of Appeals, *held*, affirmed in part, reversed in part. The district court erred in enjoining implementation of the segregation requirement because the Commission's decision to impose such a requirement was a reasonable exercise of its discretionary power to protect the public and was made only after deliberate analysis of the problem and alternative solutions. *British American Commodity Options Corp. v. Bagley*, 552 F.2d 482 (2d Cir. 1977), *cert. denied*, 46 U.S.L.W. 3306 (1977).

II. Legal Background

The commodity option has long been used by commodity dealers as a legitimate investment technique to serve as a hedge against an increase or decrease in the price of the commodity underlying the option.[17] In the early 1970s the United States experienced a new development in investments with the rapid growth of sales of "naked commodity options"—option contracts that were not supported by an underlying stock of the commodity owned by the optioner.[18] Dealing in such "naked options" allowed firms with a minimum investment of capital to sell options, to use the investor's funds to purchase and sell more options, and to parlay small sums into large gains with little or no underlying security for the

14. The terms of these protections are different on the various London exchanges. Contracts cleared through the ICCH are guaranteed through its $8.5 million capital base. Options traded on the London Metals Exchange, however, are guaranteed only to the extent that member firms comply with the Exchange's recommendation that funds received for customer accounts be escrowed. Compliance with this recommendation by member firms is purely discretionary. *See* Long, *supra* note 6, at 111-20.

15. British American Commodity Options Corp. v. Bagley, No. 76-5124 (S.D.N.Y., filed Nov. 15, 1976).

16. 552 F.2d at 490.

17. Long, *The Naked Commodity Option as a Security*, 15 Wm. & Mary L. Rev. 211, 219 (1973). This article presents an excellent explanation of the nature of naked commodity option trading and advocates treatment of such trading under the securities laws.

18. *Id.* at 211-12.

investor.[19] This procedure resulted in considerable instability, as was evidenced by the collapse of one commodity firm, which left unsatisfied option holder claims of between $14 and $85 million.[20] In response to the trouble in the options industry, Congress developed legislation to effectively regulate the entire commodities industry,[21] which resulted in passage of the Commodity Futures Trading Commission Act of 1974. The Act established the Commission as an independent regulatory agency empowered to promulgate regulations governing trading in commodities.[22] The Act gave the Commission specific power to regulate or prohibit trade in option contracts.[23] Agency authority to "legislate" through rulemaking has long been recognized in the United States, the question of whether such rulemaking violated due process having been answered over sixty years ago by the Supreme Court in *Bi-Metallic Investment Co. v. State Board of Equalization.*[24] In that case, the Court upheld the decision of Colorado state tax officials to increase the valuation of all taxable property in the city of Denver without affording affected persons an evidentiary hearing. The Court held that due process does not require a formal evidentiary hearing prior to administrative agency action which affects a large group

19. One such firm, Goldstein Samuelson, Inc., began with an initial investment of $800. Two years later, when it was adjudged bankrupt, the firm had sold over 175,000 options with a value of $88 million. No further investment of capital had ever been made. Long, *supra* note 6, at 214.

20. Long, *supra* note 17, at 218 n.28. *See also* H.R. REP. No. 93-975, 93rd Cong., 2d Sess. 36, 37 (1974) placing the amount at $71 million.

21. H.R. REP. No. 93-975, 93rd Cong., 2d Sess. 36-53 (1974). The difficulty of controlling commodity transactions under the Securities and Exchange Commission Regulations had been pointed out in a number of court decisions, which are split on the question of whether such transactions fall within the Securities Exchange Act of 1934. *Compare* Securities and Exchange Commission v. Continental Commodities Corporation, 497 F.2d 516 (5th Cir. 1974) (holding commodity options contracts fell within the definition of "securities" under the Securities Exchange Act of 1934) *with* Glazer v. National Commodity Research and Statistical Services, Inc., 547 F.2d 392 (7th Cir. 1977) (holding sale of option contracts not a sale of securities under the federal securities laws).

22. 7 U.S.C. §§ 1-22 (Supp. V 1975).

23. 7 U.S.C. § 6c(b) (Supp. V 1975) provides:

> No person shall offer to enter into, enter into, or confirm the execution of any transaction . . . which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . . .

24. 239 U.S. 441 (1915).

of people equally.[25] Congress underscored the validity of that holding when it passed the APA and provided for two types of rulemaking procedures. The first, set out in section 4 of the APA, only requires notice of proposed rulemaking and an opportunity for public comment.[26] The second procedure, established in section 7, calls for holding full evidentiary hearings, with subsequent formulation of rules based on the evidence presented.[27] This latter procedure is to be used to promulgate rules that are required by statute to be made on the record after opportunity for agency hearing.[28] The question of what type of statutory language requires section 4 or section 7 procedures was first answered by the Supreme Court in *United States v. Florida East Coast Railway Company*.[29] In that case, the Court was faced with a challenge to Interstate Commerce Commission regulations promulgated under an act which provided that "the Commission may, after hearing, . . . establish reasonable rules, regulations and practices . . . ."[30] The Court held that the statutory language required only the "notice and comment" procedures of section 4, and not an evidentiary type hearing, because it did not require the rules to be made "on the record" of such hearing.[31] Such an initial determination of which rulemaking procedure must be followed is essential to an analysis of the permissible scope of judicial review of challenged rules. Generally, judicial review of a rule involves an inquiry into the validity of the underlying statute, the conformity of the rule to the statute, and

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25. *Id.* at 445.

26. 5 U.S.C. § 553 (1970) provides in part:

> (b) General notice of proposed rule making shall be published in the Federal Register . . . .
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> (c) After notice required by this section, the agency shall give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation.

For a concise but excellent study of the rulemaking process and the sources cited there, see Levinson, *Presidential Self-Regulation Through Rulemaking*, 9 VAND. J. TRANSNAT'L L. 695, 702-10 (1976).

27. 5 U.S.C. § 556 (1970) requires an adjudicatory hearing to be held with witnesses giving sworn testimony and a trial-type transcript of the proceedings to be used for rulemaking decisions.

28. 5 U.S.C. § 553(c) (1970) further provides: "When rules are required by statute to be made on the record after opportunity for an agency hearing, sections 556 and 557 of this title apply instead of this section."

29. 410 U.S. 224 (1973).

30. *Id.* at 225 n.1.

31. *Id.* at 238; Mobil Oil Corp. v. F.P.C., 483 F.2d 1238, 1251 (D.C. Cir. 1973); Duquesne Light Co. v. F.P.A., 481 F.2d 1, 6 (3d Cir. 1973).

the adequacy of the procedures followed by the agency in promulgating the rule.[32] Once these preliminary inquiries have been completed, the substance of the rule is examined on one of two grounds. Rules promulgated under the formal trial-type procedures of section 7 must be supported by substantial evidence on the record of the hearing.[33] Those rules made under section 4 procedures are examined with more deference for agency decisions and are overturned only if they are arbitrary and capricious, or otherwise an abuse of discretion.[34] In prescribing the parameters for the arbitrary and capricious standard of review, the Supreme Court stated, in *Citizens To Preserve Overton Park, Inc. v. Volpe*,[35] that the court must make a searching and careful inquiry into the facts to determine whether there has been a clear error of judgment.[36] The "clear error of judgment" standard has been further defined as an error "so clear as to deprive the agency's decision of a rational

32. 5 U.S.C. § 706 (1970) provides:

> To the extent necessary to decision and when presented, the reviewing court shall decide all relevant questions of law, interpret constitutional and statutory provisions, and determine the meaning or applicability of the terms of an agency action. The reviewing court shall—
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> . . . .
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> (2) hold unlawful and set aside agency action, findings, and conclusions found to be—
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> (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law;
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> (B) contrary to constitutional right, power, privilege or immunity;
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> (C) in excess of statutory jurisdiction, authority or limitations, or short of statutory right;
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> (D) without observance of procedure required by law;
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> (E) unsupported by substantial evidence in a case subject to sections 556 and 557 of this title or otherwise reviewed on the record of any agency hearing provided by statute;
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> . . . .
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> In making the foregoing determinations, the court shall review the whole record or those parts of it cited by a party, and due account shall be taken of the rule of prejudicial error.

For an excellent discussion of the scope of judicial review, see Wright, *The Courts and the Rulemaking Process: The Limits of Judicial Review*, 59 CORNELL L. REV. 375 (1974).

33. 5 U.S.C. § 706(2)(E) (1970).

34. 5 U.S.C. § 706(2)(A) (1970).

35. 401 U.S. 402 (1971).

36. *Id.* at 416; Nat'l Nutritional Foods Assoc. v. Weinberger, 512 F.2d 688, 703 (2d Cir. 1975); Natural Resources Defense Council v. E.P.A., 507 F.2d 905, 917 (9th Cir. 1974).

basis."[37] In no case, however, is the court allowed to substitute its judgment for that of the agency.[38]

III. The Instant Decision

The challenge to the Commission's rules presented the court with a question of first impression. The court relied upon the provisions of the APA to determine the scope of its review and agreed with the district court that the appropriate test to apply was the arbitrary and capricious standard.[39] The court then proceeded to analyze the merits of plaintiffs' five allegations, affirming the lower court's grant of summary judgment on all the challenges except the segregation requirement, on which it reversed the district court. First, in supporting the Commission's implementation of the rules only fifteen days after publication, the court found that the notice published with the rules, which stated the rationale for accelerated implementation,[40] was sufficient to meet the test of "good cause found and published with the rule."[41] The court therefore held that the procedural requirements of section 4 had not been violated. Turning next to the plaintiffs' challenge to the registration requirements, the court upheld those provisions based on a factual investigation of the procedure and its subsequent application. While recognizing that the Commission's laudable intent to protect the public could not, by itself, justify unbridled freedom of action, the instant court looked at the entirety of the rulemaking process and found no prejudice to the petitioners. The court further found that the practice of the Commission to arbitrarily prohibit a dealer from conducting business simply by failing to process his registration application prior to the January 17th deadline was not prejudicial since due notice had been given to all dealers that registration applications should be submitted at an early date.[42]

37. Ethyl Corp. v. E.P.A., 541 F.2d 1, 35 n.74 (1976).

38. Citizens to Preserve Overton Park, Inc. v. Volpe, 401 U.S. 402, 416 (1971).

39. 552 F.2d at 490. The court's conclusion on this question was made as an affirmative statement without any reported analysis of the rationale for the conclusion.

40. 41 Fed. Reg. 51808-17 (1976).

41. 5 U.S.C. § 553(d) (1970).

42. In its November 24th announcement, the Commission stated:

> [T]he Commission again wishes to advise affected persons to file their applications for registration promptly. The Commission is already processing applications for registration which it has received as a result of its announcement of the proposed interim rules. A person who defers filing an application runs the risk that the application may not be processed before

The court noted that only two firms were affected by this practice, and both applications had been filed too close to the registration deadline.[43] In similar fashion, the instant court rejected plaintiffs' challenge to the disclosure requirements of section 32.5 of the Regulations by closely analyzing what occurred in the instant case. The court held that the challenge lacked substance in light of the Commission's rationale for the rule[44] and the subsequent effect on trading.[45] The court based this holding on its finding that, although the disclosure requirements would operate to "cool the public's ardor for options,"[46] the purpose of the rule was to help investors make informed judgments. The court pointed out that the plaintiffs' showing of decreased sales under the disclosure requirements actually supported the Commission's position.[47] With respect to plaintiffs' fourth charge, the court saw nothing arbitrary and capricious in the requirement that option dealers maintain a minimum capital balance in excess of that required for commodity futures dealers. Based on the range of abuses in the options industry resulting from thinly capitalized endeavors, and the Commission's finding that losses are more likely to arise in the commodity options area,[48] the court found that the Commission could properly impose greater working capital requirements on option dealers. In ruling on the plaintiffs' challenge to the segregation requirement

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the January 17th deadline. Normal requirements for processing are 30-60 days. While the Commission intends to expedite the processing of applications, a prompt filing will enable the Commission to do so on a timely basis.

41 Fed. Reg. 51810 (1976).

43. 552 F.2d at 491.

44. This disclosure statement is required to be furnished to option customers in advance of purchase so as to familiarize them with certain aspects of the option transaction. The Commission is aware that a significant number of commodity option transactions currently are being offered and sold through the use of high-pressure sales tactics to persons who are relatively unfamiliar with the commodities markets generally, and with commodity options in particular. The Commission is also aware that at the present time even when disclosure is made to option customers, it is often inaccurate or misleading either in content, presentation, or both.

41 Fed. Reg. 44564 (1976).

45. British American figures, *supra* note 11.

46. 552 F.2d at 492.

47. *Id.*

48. The Commission further stated: "Based on its experience, . . . the Commission believes that the distinction in working capital requirements between futures commission merchants who are engaged in options activity as opposed to those who are not, is necessary to provide a cushion against losses which are more likely to arise in the commodity options areas." 41 Fed. Reg. 51813 (1976).

of section 32.5 of the Regulations, however, the instant court disagreed with the district court. The instant court again relied upon the underlying purpose of the Act in differing with the district court's conclusion that segregation could serve to force many dealers out of business. The instant court found that any vulnerability of such firms to possible elimination from the business indicated their lack of substantial capital, thus confirming the need for such protective regulation.[49] The court pointed out that restricting options trading to soundly capitalized firms would not violate the intent of the Act since Congress had clearly given the Commission the authority to totally prohibit option trading if it saw fit to do so. Most importantly, the court found that the Commission was acting within the intent of the Act in light of Commission findings that protections established for the London Market did not extend to American customers.[50] The court thus concluded that the Commission had not acted arbitrarily and capriciously with respect to any of the plaintiffs' allegations regarding the 1974 regulations.

IV. COMMENT

The court's decision in the instant case will have a significant impact on the trading of foreign commodity options in the United States. Using the arbitrary and capricious test, the court correctly found that the regulations were proper despite the fact that, because of the segregation rule, a dealer in foreign options will be required to raise almost the complete option purchase price from its own resources in order to secure the option on the foreign market. The segregation rule will significantly affect both foreign and domestic firms since anyone selling options in the United States is required to register with the Commission and must adhere to the segregation requirement. Thus, whether the dealer is foreign or

49. 552 F.2d at 490.

50. The Commission's findings are set out in RECOMMENDED POLICIES ON COMMODITY OPTIONS TRANSACTIONS, REPORT OF THE ADVISORY COMMITTEE ON THE DEFINITION AND REGULATION OF MARKET INSTRUMENTS TO THE COMMODITY FUTURE TRADING COMMISSION, 1976 COMM. FUT. L. REP. (CCH) Supp. 26, at 41.

While it is true that the ICCH guarantees its contracts between trading members, the dealers who sell London options in the United States are not members of any of the London Exchanges. They are therefore required to purchase their options from a dealer in London who is an exchange member. Thus, they, not the American investor, are protected by the guarantee. Frequently, the chain between the guarantee and the investor is extended even further when the dealer is a small firm which must purchase its option from a larger "option jobber" who then makes the London deal. *See*, Long, *supra* note 6, at 124-26.

domestic, if he sells foreign options in the United States he will face the double segregation problem. The implication of the court's decision, then, is that domestic firms with a limited capital structure will be forced out of dealings in foreign commodity exchanges and foreign firms will be unlikely to engage in sales in the United States due to the added economic burden. Despite that dire prospect, the court's decision may have a beneficial impact on the future of foreign option trading in the United States. The Commission has repeatedly declared that the current option regulations are part of a three-year test program in which it is engaged to determine the feasibility of regulating the option market.[51] The statutory grant of power for the Commission to totally prohibit option trading if it sees fit is still an alternative. In upholding these regulations, the court has allowed the Commission to regulate trading without prohibiting it. Successful control of the option industry under these regulations may enable at least some large, well capitalized dealers to trade in foreign options. Without these protections, which the Commission feels are so necessary to the American investor, it would be much more likely that the Commission would resort to a total ban on option trading. Thus, even though the decision will undoubtedly force some thinly capitalized firms from the business, it may have the ultimate effect of enabling at least some trading of foreign options in the United States to continue.

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51. 41 Fed. Reg. 51808 (1976).

CUSTOMS—COUNTERVAILING DUTIES—REBATES OF NONEXCESSIVE EXCISE TAXES DO NOT CONSTITUTE A BOUNTY SUBJECT TO COUNTERVAILING DUTIES

I. FACTS AND HOLDING

Plaintiff, a domestic electronic equipment manufacturer,[1] filed a complaint with the Treasury Department[2] petitioning for the imposition of countervailing duties on similar electronic imports from Japan.[3] Plaintiff alleged that the Japanese remission of commodity taxes on these products[4] constituted the bestowal of a "bounty or grant" pursuant to the Tariff Act of 1930.[5] The Secretary of the Treasury published a Final Negative Countervailing Duty Determination announcing that no bounty existed within the meaning of the Act.[6] Plaintiff appealed, contending that as a matter of law a bounty existed whenever the government of Japan imposes a commodity tax upon the manufacture of specified products for domestic shipment and consumption, while granting a tax

1. Zenith Radio Corporation, the largest United States producer of color television sets, manufactures electronic products for consumer use.

2. 19 C.F.R. § 16.24(b) (1971) provided that "[a]ny person outside the Customs Service who has reason to believe that any bounty or grant is being paid or bestowed with respect to dutiable merchandise imported into the United States may communicate his belief to the district director of the Commissioner of Customs."

3. The products include television receivers, radio receivers, radio-phonograph combinations, radio-television-phonograph combinations, radio-tape recorder combinations, record players and phonographs complete with amplifiers and speakers, tape recorders, and parts of television receivers. 37 Fed. Reg. 10087 (1972), *as amended*, 37 Fed. Reg. 11487 (1972).

4. Commodity Tax Law, Law No. 48 (Japan 1962), *as amended*, is a single-stage consumption tax which is levied at the manufacturing level on certain specified electronic products. Rates of tax range generally from 5 to 40 percent. Upon exportation of these products from Japan, the tax is either remitted, if previously paid, or the products are exempted from the payment of tax. Zenith Radio Corp. v. United States, 430 F. Supp. 242, 243 (Cust. Ct. 1977).

5. 19 U.S.C. § 1303(a)(1) (1970 & Supp. V 1975). This section reads in part:

> Whenever any country . . . shall pay or bestow, directly or indirectly, any bounty or grant upon the manufacture or production or export of any article or merchandise manufactured or produced in such country . . . then upon the importation of any such article or merchandise into the United States, whether the same shall be imported directly from the country of production or has been changed in condition by remanufacture or otherwise, there shall be levied and paid . . . in addition to the duties otherwise imposed by this chapter, an additional duty equal to the net amount of such bounty or grant, however the same be paid or bestowed.

6. 41 Fed. Reg. 1298 (1976).

exemption for those products when exported. The Secretary, relying on legislative history and administrative practice, claimed that only "excess" tax remissions can be considered bounties and that the decision not to countervail was binding since the Treasury Department has been empowered to make bounty determinations. The Customs Court granted summary judgment in favor of plaintiff and ordered the imposition of countervailing duties.[7] The Court of Customs and Patent Appeals, *held*, reversed. Nonexcessive remissions of excise taxes that are levied on products manufactured for domestic consumption, but refunded upon the exportation of those products, do not constitute "bounties or grants" subject to the assessment of countervailing duties under the Tariff Act. *United States v. Zenith Radio Corp.*, 562 F.2d 1209 (C.C.P.A. 1977).

II. LEGAL BACKGROUND

The first United States countervailing duty[8] applicable to all imports otherwise dutiable was enacted under the Tariff Act of 1897.[9] It authorized the Secretary of the Treasury to determine the existence of any "bounty or grant" on dutiable goods imported into the United States and mandated the imposition of a countervailing duty in the amount of the determined subsidy.[10] These provisions were expanded in the Tariff Act of 1930.[11] However, the term "bounty or grant" has not been defined by any statute or administrative regulation. In *Downs v. United States*,[12] the Supreme Court

7. 430 F. Supp. 242. Relying heavily upon Downs v. United States, 187 U.S. 496 (1903), the three-judge court held that remission of the Japanese commodity tax constituted a bounty or grant under the Tariff Act as a matter of law.

8. Two earlier statutory duties were limited to protecting United States sugar producers from foreign competitors. Tariff Act of 1894, ch. 349, § 1, 28 Stat. 521; Tariff Act of 1890, ch. 1244, § 237, 26 Stat. 584.

9. Tariff Act of 1897, ch. 11, § 5, 30 Stat. 205.

10. Countervailing duties attempt to guarantee that products will compete according to their relative merits without the benefit of price reductions made possible by the receipt of bounties or grants. Butler, *Countervailing Duties and Export Subsidization: A Re-Emerging Issue in International Trade*, 9 VA. J. INT'L L. 82, 83 (1968).

11. 19 U.S.C. § 1303 (1930) *amended by* Act of Jan. 3, 1975, Pub. L. No. 93-618, Title III, ch. 3, § 331(a), 88 Stat. 2049. *See generally*, Butler, *supra* note 10; Feller, *Mutiny Against the Bounty: An Examination of Subsidies, Border Tax Adjustments, and the Resurgence of the Countervailing Duty Law*, 1 L. & POL'Y INT'L BUS. 17 (1969); King, *Countervailing Duties—An Old Remedy with New Appeal*, 24 BUS. LAW. 1179 (1969).

12. 187 U.S. 496 (1903).

scrutinized a Russian plan that exempted sugar exports from the regular excise tax and granted negotiable certificates to sugar exporters. Since these certificates, which acted as drawbacks of an additional excise tax imposed on production surpluses, were issued only upon the exportation of sugar, the Court determined that a bounty existed that warranted countervailing duties. In *Nicholas & Co. v. United States,*[13] the Court examined a British system that, in addition to relieving liquor exporters of the inland excise tax, paid exporters an "allowance," which in effect created an export benefit. The Court held that the allowance constituted a bounty. The broad language in *Downs*[14] and *Nicholas*[15] suggests that indirect tax remissions of any sort constitute bounties subject to countervailing duties. In neither case, however, did the Court distinguish between a remission of an amount exceeding the original tax payment and indirect tax remissions rebating the amount paid. Although an historical analysis indicates that the broad language in *Downs* and *Nicholas* is dictum,[16] recent decisions have challenged this view.[17] In *Hammond Lead Products, Inc. v. United States,*[18] the Customs Court, relying on *Downs,* reversed the Secretary's determination not to countervail Mexican exports of lithage.

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13. 249 U.S. 34 (1919).

14. The Court stated that "[w]hen a tax is imposed upon all sugar produced, but is remitted upon all sugar exported, then, by whatever process, or in whatever manner, or under whatever name it is disguised, it is a bounty upon exportation." 187 U.S. at 515.

15. The Court stated:

> If the word "bounty" has a limited sense the word "grant" does not. A word of broader significance than "grant" could not have been used. Like its synonyms "give" and "bestow," it expresses a concession, the conferring of something by one person upon another. And if the "something" be conferred by a country "upon the exportation of any article or merchandise," a countervailing duty is required . . . .

249 U.S. at 39.

16. For authority supporting the contention that the noted language is dictum, see Department of the Treasury of the United States, *Countervailing Duties,* 1 UNITED STATES INTERNATIONAL ECONOMIC POLICY IN AN INTERDEPENDENT WORLD: PAPERS SUBMITTED TO THE COMMISSION ON INTERNATIONAL TRADE AND INVESTMENT POLICY 411 (1971); Butler, *supra* note 10, at 119; *The Michelin Decision: A Possible New Direction for U.S. Countervailing Duty Law,* 6 LAW & POL'Y INT'L BUS. 237, 248 (1974).

17. For authority that the holding language is not dictum, see American Express Co. v. United States, 332 F. Supp. 191, 197-99 (Cust. Ct. 1971), *aff'd on other grounds,* 472 F.2d 1050 (C.C.P.A. 1973); King, *supra* note 11, at 1182-83.

18. 306 F. Supp. 460 (Cust. Ct. 1969), *rev'd,* 440 F.2d 1024 (C.C.P.A. 1971), *cert. denied,* 404 U.S. 1005 (1971).

On appeal, it was held that the lower court lacked jurisdiction to review a negative determination. The court further rejected the lower court's reliance on the *Downs* dicta that any government measure calculated to encourage exports constitutes a bounty. In *American Express Co. v. United States,*[19] the trial court examined Italy's refund of "basic rate taxes"[20] on exports of electronic components, and concluded that a bounty existed. By countervailing against the full amount of the remission, the court abandoned the policy of focusing solely on excessive indirect tax rebates and upheld a broad interpretation of *Downs.* Although the appellate court affirmed the decision, it based its conclusion on an evaluation of the nature of the taxes involved, not on the lower court's rationale. Despite the broad language in *Downs* and *Nicholas,* the Treasury Department's practice has been to interpret the statute narrowly and to require countervailing duties only in cases of excess tax remissions.[21] This interpretation is consistent with the General Agreements on Tariffs and Trade (GATT),[22] which restricts the imposition of countervailing duties.[23] However, the United States observes GATT through a Protocol of Provisional Application which allows the enabling provision of the Tariff Act to take pre-

19. 332 F.Supp. 191 (Cust. Ct. 1971), *aff'd,* 472 F.2d 1050 (C.C.P.A. 1973).

20. The taxes rebated included customs duties and other import charges, registration, stamp, insurance, mortgage, advertising and publicity taxes and surtaxes of aforementioned taxes. 332 F. Supp. at 195-96.

21. Treasury's administrative practice and its rationale was described to Congress in SENATE COMM. ON FINANCE, 93D CONG., 2D SESS., EXECUTIVE BRANCH GATT STUDIES, 11-12 (1974):

> Under administrative precedents dating back to 1897, the Treasury Department has generally not construed the rebate, remission or exemption of ordinary indirect taxes (consumption taxes or goods) to be a "bounty or grant" within the meaning of our countervailing duty statute . . . . [S]ince exports are not consumed in the country of production, they should not be subject to consumption taxes in that country . . . [and] application of countervailing duties would have the effect of double taxation.

22. Oct. 30, 1947, 61 Stat. A23, T.I.A.S. No. 1700, 55 U.N.T.S. 187, [hereinafter cited as GATT].

23. GATT was established upon the premise that governmental intervention should be reduced in the international arena to permit the market to determine the flow of international trade. Three underlying objectives characterize GATT: (1) the use of unconditional most-favored-nation treatment, (2) the reduction of tariffs, and (3) the elimination of quantitative restrictions upon trade flow. *See* Weiss, *The General Agreement on Tariffs and Trade: An Assessment,* in 2 UNITED STATES INTERNATIONAL ECONOMIC POLICY IN AN INTERDEPENDENT WORLD: PAPERS SUBMITTED TO THE COMMISSION ON INTERNATIONAL TRADE AND INVESTMENT POLICY 452 (1971).

cedence over article VI of GATT.[24] Article VI authorizes countervailing duties only when injury to a domestic industry occurs and does not permit indirect tax rebates to constitute bounties.[25] The absence of comparable provisions in the Tariff Act facilitates protectionist uses of the statute. Yet, in accordance with GATT and administrative practices, courts generally interpret the Tariff Act narrowly and do not impose countervailing duties in cases of nonexcessive tax remissions.

III. The Instant Opinion

In the instant case, the court determined that this was a case of first impression, and that no judicial authority existed for countervailing any remitted taxes that are not excessive in nature. Beginning with this narrow interpretation of *Downs* and *Nicholas,* the court's review of applicable cases established that, as in *Downs,* the bounty or grant in each case was found to reside in and was measured by an excess over the remission of the excise taxes.[26] Moreover, the court determined that nothing in the statute or its legislative history mandated that as a matter of law the Japanese remission of taxes be deemed a bounty. Instead, the court reasoned that since the statute afforded the Secretary wide discretion in

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24. When the United States and other nations acceded to GATT, they agreed to undertake Part II which includes article VI "to the fullest extent not inconsistent with existing legislation." Protocol of Provisional Application of the GATT, Oct. 30, 1947, 61 Stat. A2051, T.I.A.S. No. 1700, 55 U.N.T.S. 308.

25. Article VI, section 5 of GATT provides:

> No contracting party shall levy any anti-dumping or countervailing duty on the importation of any product of the territory of another contracting party unless it determines that the effect of the dumping or subsidization, as the case may be, is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry.

61 Stat. A24 (1947).

Article VI, section 3 of GATT states:

> No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes.

61 Stat. A24 (1947). Marks & Malmgren, *Negotiating Nontariff Distortions to Trade,* 7 Law & Pol'y Int'l Bus. 327, 351 (1975) observes that "[u]nder GATT Article VI(4), [*sic* [VI(3)]], any rebates, upon exportation, of direct taxes . . . are impliedly countervailable, while rebates of indirect taxes are not countervailable."

26. 562 F.2d 1209, 1213 (C.C.P.A. 1977).

countervailing, the finding of a bounty was a factual issue that the courts were ill-equipped to review.[27] Further, the court stated that the legislative history indicated that the term "bounty" cannot be defined absolutely. Such a determination, the court noted, necessarily requires an investigation of political, legislative, and economic considerations.[28] Finding no binding judicial, statutory, or legislative interpretations regarding the relationship of bounty determinations to nonexcessive remissions of taxes, the court examined the Treasury Department's administrative practices. The court found that the Secretary had consistently interpreted section 303 as requiring excessive tax remissions before declaring a bounty.[29] Furthermore, the court found congressional acquiescence in this practice since Congress had not enacted contrary legislation. The court concluded that this established administrative

27. The court reasoned that since neither form nor nomenclature was decisive in determining whether a bounty had been conferred, it was the economic result of a foreign government's action which controls. The court presumed the Secretary had determined that the economic result here did not confer a bounty. This finding was not at issue. *Id.* at 1216.

28. In considering the results of assessing a countervailing duty, one leading commentator wrote:

> It should be recognized that countervailing duty actions amount to a public reproach to the affected foreign governments for promoting "unfair competition." The political, diplomatic and psychological complications can be extensive and may adversely affect the general relations of the United States with those countries. The fact that by its terms the law applies without qualifications to production subsidies, as well as to export subsidies, can create additional problems along these lines. One can readily imagine that countervailing on the basis of a production subsidy might be viewed as interference in the domestic affairs of the exporting country, particularly if the production subsidies neither yield an appreciable increase in exports, nor were intended to do so.

Feller, *supra* note 11, at 64.

29. The Treasury has not countervailed indirect taxes unless the resulting tax remission is excessive. The theory relied upon is that indirect taxes are completely shifted forward to the ultimate consumer in the form of higher prices, whereas direct taxes are fully absorbed by the manufacturing entity and are reflected in reduced wages and dividends. The remission of excise taxes would have no effect on a manufacturer's decision to export. Any attempt to countervail the indirect tax remission would create double taxation since the United States would not only impose its own indirect taxes, but would collect through the use of countervailing duties the indirect tax imposed by the exporting country on domestically consumed goods. This theory does not recognize the difficulty in classifying taxes as direct and indirect, and in determining tax shifting. *See* King, *supra* note 11, at 1187-89; Note, *The Steel Products Decision: An Inquiry Into the Treatment of the Value-Added Tax Under the Countervailing Duty Law*, 9 VAND. J. TRANSNAT'L L. 819 (1976).

practice, which has been free of conflicts with the law, was entitled to great weight.[30] Therefore, the court held that countervailing duties are not imposed in cases of nonexcessive tax remissions since no bounty exists within the meaning of section 303 of the Tariff Act. The dissenting opinion asserted that the controlling question of the existence of a bounty was a matter of law, not an unreviewable factual determination made by the Secretary. The dissent reasoned that the key language of the statute had been interpreted by *Downs* and reinforced in *Nicholas* so that any remissions of excise taxes constitute bounties. Consequently, this judicial interpretation should prevail over administrative practices. The dissent found congressional acquiescence in this interpretation since Congress had not amended the statute. Thus, the dissent claimed that section 303 required the imposition of countervailing duties in cases of nonexcessive tax remissions.

IV. COMMENT

By distinguishing legal precedents and upholding administrative practices, the instant court adopted a policy which supports GATT and concepts of international free trade. Due to the split in the decision, the court could have easily interpreted the precedents as applicable and reinforced the protectionist stand on trade relations. Although it is a proper exercise of judicial power to interpret and apply the law unrestrained by extra-legal considerations, the problem considered by the instant court is an example of conflicting domestic and international trade interests strongly influencing judicial determinations. The Customs Court decision to impose countervailing duties was handed down in the wake of mounting protectionist movements[31] and an International Trade Commission (ITC) ruling ordering import restrictions.[32] Although the decision

30. Saxbe v. Bustos, 419 U.S. 65, 74 (1976). The court also stated that to sustain an administrative interpretation of a statute a court need not find that interpretation to be the only reasonable one, or even the result the court would have reached had the question arisen first in a judicial proceeding. 562 F.2d at 1219-20.

31. A series of cases involving demands by United States producers for protection from foreign goods were investigated by the United States International Trade Commission (ITC) and the courts. The threatening imports included television sets, steel, sugar, and shoes. Wall St. J., March 23, 1977 at 44, col. 1.

32. The ITC ruled that television imports had injured domestic industries and recommended that the 5% import duty be increased to 25%. According to ITC figures, imports of all types of television receivers totaled nearly 7.8 million units in 1976, up from 4.2 million in 1975. Japan's export volume had captured more

meant that other domestic industries were eligible for protection,[33] it also portended higher prices for manufactured goods.[34] The court's ruling further represented a serious challenge to international trade. Not only could domestic exporters encounter retaliatory trade barriers, but the United States faced a possible loss of bargaining power at GATT negotiations.[35] In what may have been a reaction to GATT challenges and government pressures, the instant court reaffirmed the traditional concept of countervailing duties—that nonexcessive tax rebates do not constitute bounties. However, the court narrowed its decision to upholding an administrative agency's factual determination. The court, while appearing to foreclose the use of the *Downs* dictum in cases of nonexcessive tax remissions continued to leave the determination of a bounty to the Treasury Secretary's discretion. In so doing, the court reflected the view that judicial review of administrative decisions is frequently inappropriate when expanded to make policy decisions on complex issues such as international trade.[36] The Supreme

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than 30% of the United State's market. Wall St. J., April 11, 1977, at 7, col. 1; *id.*, March 15, 1977, at 3, col. 1.

33. Most United States trading partners rebate indirect taxes to their exporters. According to one Treasury estimate, the court's ruling could have affected 60 to 70% of all United States imports. The U.S. Steel Corp. immediately cited the Customs Court decision in a similar case involving tax rebates on European steel shipments to the United States. Wall St. J., June 27, 1977, at 17, col. 3; *id.*, April 13, 1977, at 2, col. 3.

34. Increasing tariffs for the purpose of achieving greater protection for domestic products not only causes a decrease in government revenue, but also causes domestic consumers to turn to domestic suppliers. A demand is created greater than the supply available, and consequently, prices increase. Also, increasing tariffs bar lower-priced imports, thereby stifling competition.

35. The GATT warned the United States that it risked legal retaliation if the Customs Court decision in the instant case were upheld. It declared that the decision would have adverse consequences for world trade, multilateral trade negotiations, and the GATT system itself. The Japanese government and the European Community further informed the United States to expect retaliatory trade actions if the courts were finally to decide countervailing duties were required to offset the rebating of Japanese commodity taxes or the widely used value-added tax. Wall St. J., June 17, 1977, at 12, col. 1; *id.*, July 29, 1977, at 3, col. 1.

36. Under existing standards, courts may narrow their review to satisfy the demands for administrative discretion, or they may broaden it to the point of substituting their judgment for that of the administrative agency. However, administrative interpretations are given great weight because the enforcement agency has the requisite expert knowledge and judgment. REPORT OF THE ATTORNEY GENERAL'S COMMITTEE ON ADMINISTRATIVE PROCEDURE 87-88, 90-91 (1941).

Court would have valid grounds to affirm this view.[37] However, in light of the increasing use of countervailing duties and other nontariff barriers in international trade, more definitive and effective guidelines are needed to reflect economic realities and trade policies.[38] Multiple national exchange agreements have emerged as temporary measures aimed at limiting imports.[39] These agreements have largely been uncoordinated, yet they threaten international free trade. While GATT negotiations seem to be the most effective means of controlling these trade restrictions, a workable system will not be possible without reciprocal concessions among nations.[40] In return for assurances that unfair export subsidies and border tax adjustments will be abandoned, the United States will need to interpret or amend section 303 of the Tariff Act to adhere more faithfully to international understandings. First, inquiries into the price competitiveness of bountified imports should be required. Second, a material injury to domestic industry should exist before imposing countervailing duties.[41] Third, a set of standards for determining the existence and amount of a bounty should be delineated to avoid vague, inconsistent, or unfair countervailing duty determinations. More importantly, while countervailing duties can be effective trade instruments in remedying inequitable tax practices, their use as retaliatory measures should be avoided.

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37. Zenith not only appealed the instant court's decision to the Supreme Court, but it also filed civil antitrust claims against a number of Japanese manufacturers. Since the instant court's ruling, Zenith has laid off nearly one-fourth of its work force and transferred a substantial part of its manufacturing operation out of the country. In 1976, Zenith earned $38.6 million, or $2.05 per share. By comparison, in the first half of 1977, Zenith earned $13.5 million, or $0.72 per share. Wall St. J., Sept. 28, 1977, at 2, col. 2.

38. This view is supported by a report from the International Monetary Fund:

> [A] greater proportion of world trade recently has become subject to such restraints as import surcharges, quotas, trade-limiting pacts and various other nontariff barriers. The trend—ranging from West European restraints on textile imports to Japanese restrictions on silk to Indonesian curbs on iron and steel—marks an interruption to the reduction of protectionism that has characterized the policies on most major trading nations.

Wall St. J., Aug 11, 1977, at 1, col. 7.

39. *See* N.Y. Times, May 18, 1977, at A 1, col. 1.

40. *See* Lewis, *Protectionism Plagues Free-Trade Talks,* N.Y. Times, Oct. 2, 1977, at F4, col. 4.

41. Implicit in these provisions is the assumption that no useful purpose is served by imposing duties unless a subsidy tends to cause injury or prevent the establishment of a competing domestic industry. These provisions would diminish the resentment caused by the statute and bring United States law in conformity with article VI of GATT.

Finally, since the costs of protectionism are so great,[42] future judicial review should be cautious.

Shelley B. O'Neill

42. The costs of protectionism include increasing consumer prices, loss of jobs for United States export industries, impaired national industrial alliances, restrictions on free trade growth, and greater inefficiency in domestic industries.

JURISDICTION—EXERCISE OF IN REM AND QUASI IN REM JURISDICTION JUSTIFIED ONLY WHERE *International Shoe* MINIMUM CONTACTS STANDARD IS SATISFIED

I. FACTS AND HOLDING

Plaintiff, a stockholder in a Delaware parent corporation,[1] brought a shareholder's derivative suit[2] in Delaware against the parent, its subsidiary,[3] and 28 present or former corporate officers and directors.[4] Upon filing its complaint, plaintiff also moved for a writ of sequestration[5] to attach all Delaware property of the 28 individual defendants. The trial court subsequently issued a writ of sequestration on the Delaware property, which consisted of stock and options to purchase stock of the parent corporation, all statutorily[6] located in Delaware. The individual defendants entered a

1. Greyhound Corporation, the parent, is incorporated under the laws of Delaware with its principal place of business in Phoenix, Arizona.

2. The shareholder's derivative suit alleged violation of fiduciary duties by defendant officers and directors resulting in the corporation's liability for substantial damages in a private antitrust suit and for a large fine in a criminal contempt action.

3. Greyhound Lines, Inc. is incorporated in California with its principal place of business in Phoenix, Arizona.

4. There are no allegations in the record that any of the individual defendants have had any contacts with Delaware except as officers and directors of a Delaware corporation.

5. Writ of sequestration is governed by DEL. CODE ANN. Tit. 10, § 366 (1974) which provides as follows:

> (a) If it appears . . . that the defendant . . . is a nonresident . . . the Court may make an order directing such nonresident . . . to appear by a day certain . . . . Such order shall be served . . . by mail . . . and . . . published . . . . The Court may compel the appearance of the defendant by the seizure of all . . . his property . . . . Any defendant whose property shall have been so seized and who shall have entered a general appearance in the cause may . . . , petition the Court for an order releasing such property . . . from the seizure.

The Delaware sequestration statute is unique because it allows the court to compel nonresident defendants to make a general appearance based on in rem or quasi in rem jurisdiction over the nonresident's Delaware property. *See* Folk & Moyer, *Sequestration in Delaware: A Constitutional Analysis*, 73 COLUM. L. REV. 749 (1973).

6. Stock of corporations organized under the laws of Delaware is statutorily sited in Delaware pursuant to DEL. CODE ANN. Tit. 8, § 169 (1974), which provides as follows:

> For all purposes of title, action, attachment, garnishment and jurisdiction of all courts held in this State, but not for the purpose of taxation, the

special appearance to quash service of process and to vacate the sequestration on grounds that they did not have sufficient minimum contacts in Delaware to permit the state to exercise jurisdiction over them without violating the fourteenth amendment guarantee of due process. The trial court held that the statutory presence of the defendants' stock in Delaware was sufficient to permit exercise of quasi in rem jurisdiction over the defendants, finding that the sequestration statute required the defendants to make a general appearance to challenge the sequestration, thereby submitting to in personam jurisdiction. On appeal, the Delaware Supreme Court affirmed the lower court's holding,[7] finding the *International Shoe*[8] minimum contacts test inapplicable to the exercise of quasi in rem jurisdiction. On appeal to the United States Supreme Court, *reversed. Held:* A state may assert jurisdiction over nonresidents' property not related to the underlying cause of action only where there exist sufficient minimum contacts among the parties, the contested transaction, and the forum state. *Shaffer v. Heitner*, 433 U.S. 195, 97 S. Ct. 2569, 53 L.Ed.2d 683 (1977).

II. LEGAL BACKGROUND

State power to exercise jurisdiction had been based on *Pennoyer v. Neff*[9] which held that every state possesses exclusive jurisdiction over persons and property inside its territory, and that no state can exercise direct jurisdiction over persons or property outside its territory.[10] The *Pennoyer* court also held, however, that the state

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situs of the ownership of the capital stock of all corporations existing under the laws of this State . . . shall be regarded as in this State.

7. Greyhound Corp. v. Heitner, 361 A.2d 225 (Del. 1976). The court held that Delaware could constitutionally establish Delaware as the situs of the stock.

8. International Shoe Co. v. Washington, 326 U.S. 310 (1945).

9. 95 U.S. 714 (1877). The Court refused to quiet title in a foreclosure sale purchase because the sale was held pursuant to a judgment rendered in the absence of the defendant and without first attaching the property.

10. *Id.* at 722. The initial distinction between direct and indirect jurisdiction gave rise to classifying actions as in rem and in personam (direct) or quasi in rem (indirect). The Court has further differentiated among the three different types of jurisdiction as follows:

> A judgment *in personam* imposes a personal liability or obligation on one person in favor of another. A judgment *in rem* affects the interests of all persons in designated property. A judgment *quasi in rem* affects the interests of particular persons in designated property. The latter is of two types. In one the plaintiff is seeking to secure a preexisting claim in the subject property and to extinguish or establish the nonexistence of similar interests

could exercise jurisdiction over a nonresident citizen to the extent of his property within the state.[11] The Court further recognized that a state could exercise judicial authority over persons outside its territorial confines in actions determining either the civil status of the state's citizens towards nonresidents or the rights and duties arising from relations with business entities created under the state's laws.[12] Since *Pennoyer,* the concept of state jurisdiction has developed significantly. In *Harris v. Balk*[13] the Court upheld quasi in rem jurisdiction in an action by a resident to attach a debt owed to a nonresident defendant. In *International Harvester Co. v. Kentucky*[14] the Court further developed the general theory of *Pennoyer* by holding that a corporation doing business in a state would be deemed "present" in the state for service of process. In *Hess v. Pawlowski,*[15] the Court introduced the concept of "implied consent," a further refinement of the general *Pennoyer* theory allowing states to exercise jurisdiction over nonresident motorists

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of particular persons. In the other the plaintiff seeks to apply what he concedes to be the property of the defendant to the satisfaction of a claim against him.

Hanson v. Denckla, 357 U.S. 235, 246 n.12 (1958).

11. 95 U.S. at 723.

12. *Id.* at 733-35. The exceptions to the general rule that a state lacks jurisdiction over persons not within the state's territory include the following: actions for divorce, child adoption or custody; actions against nonresident members of a partnership or association domiciled in the state; actions against nonresidents arising out of contracts expressly enforceable in the state; and actions to enforce the obligations, to investigate the conduct, or to revoke the charters of corporations or other institutions for pecuniary or charitable purposes created under that state's law. *Id.* at 735-36.

13. 198 U.S. 215 (1905). *See also,* Louisville & N. R.R. v. Deer, 200 U.S. 176 (1906) (upholding quasi in rem jurisdiction over the debt owed by a resident railroad company to a nonresident individual); Steele v. G.D. Searle & Co., 483 F.2d 339 (5th Cir. 1973), *cert. denied,* 415 U.S. 958 (1974) (upholding quasi in rem jurisdiction over debts owed by resident merchant debtors to a nonresident drug manufacturer).

14. 234 U.S. 579 (1914) (upholding in personam jurisdiction in a criminal antitrust action against a farm implements corporation carrying on interstate business touching the state). *But cf.,* Philadelphia & Reading R. Co. v. McKibbin, 243 U.S. 264 (1917) (reversing lower court holding that a railroad corporation was doing business in a state by selling tickets within the state). *See generally,* Stevenson, *Developments in the Law—State Court Jurisdiction,* 73 HARV. L. REV. 909, 919-23 (1960), which traces the development of the implied consent and presence theories of jurisdiction over corporations.

15. 274 U.S. 352 (1927). Jurisdiction was based on the legal fiction that since a state could theoretically exclude nonresident motorists they "impliedly consented" to service of process within the state by using its highways.

through substituted service on a designated state official. Judge Learned Hand stated in *Hutchinson v. Chase & Gilbert*[16] that the "presence" and "implied consent" refinements of the *Pennoyer* in personam theory were a test of what degree of contacts with the forum made it appropriate to exercise jurisdiction over nonresidents.[17] In *International Shoe Co. v. Washington*, the Court disregarded *Pennoyer's* in personam theory[18] and developed a new test--whether the nonresident had such "minimum contacts" with the forum that in personam jurisdiction did not violate "traditional notions of fair play and substantial justice."[19] *International Shoe* thereby expanded the reach of in personam jurisdiction under the various state long arm statutes.[20]

The Court has never employed the "minimum contacts" test for in rem and quasi in rem jurisdiction[21] although several lower courts[22] and many commentators[23] have suggested the "minimum

16. 45 F.2d 139 (2d Cir. 1930) (upholding a denial of in personam jurisdiction over a corporation maintaining office space in the state).

17. *Id.* at 140-41.

18. 326 U.S. at 316.

19. *Id. See also,* McGee v. International Life Ins. Co., 355 U.S. 220, 222 (1957) (upholding jurisdiction over an insurance company whose only contact with the forum state was acceptance of premiums from a forum resident); Milliken v. Meyer, 311 U.S. 457, 463 (1940) (holding that domicile within a state provided a sufficient basis for in personam jurisdiction to satisfy the "traditional notions of fair play and substantial justice implicit in due process"); *but cf.,* Hanson v. Denckla, 357 U.S. 235 (1958) (holding that a nonresident trustee did not have sufficient minimum contacts to justify in personam jurisdiction merely because it mailed income checks to and carried on correspondence with the trust's resident grantor).

20. *See generally,* Green, *Jurisdictional Reform in California,* 21 HASTINGS L.J. 1219, 1231-33 (1970), which outlines the redrafting of state jurisdictional statutes in response to *International Shoe;* Currie, *The Growth of the Long Arm: Eight Years of Extended Jurisdiction in Illinois,* 1963 U. ILL. L.F. 533, which discusses the wide range of minimum contacts developed in Illinois after *International Shoe;* Stevenson, *supra* note 14, at 1000-08, which concludes that state legislatures have not expanded jurisdiction as far as they could under *International Shoe.*

21. Shaffer v. Heitner, 97 S. Ct. at 2580. The Court states that the in rem jurisdiction holding in *Pennoyer* has not previously been overruled. The Court includes quasi in rem jurisdiction as a subset of in rem jurisdiction throughout the remainder of the opinion. *See, e.g., id.* at 2582.

22. *See, e.g.,* U.S. Industries v. Gregg, 540 F.2d 142 (3d Cir. 1976), *cert. denied,* 45 U.S.L.W. 3840 (June 28, 1977) (No. 76-359) (holding quasi in rem jurisdiction established under Delaware's statute regarding situs of corporate stock supplanted by *International Shoe's* "minimum contacts" test); Jonnet v. Dollar Savings Bank, 530 F.2d 1123, 1130-43 (3d Cir. 1976) (Gibbons, J., concur-

contacts" test should be applied to all jurisdictional questions. The Court, however, had indirectly weakened the in rem and quasi in rem branch of *Pennoyer* through several procedural due process cases. In *Schroeder v. City of New York*[24] the Court held that publication notice of condemnation proceedings against plaintiff's land failed the procedural due process standard of "notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections."[25] In *Continental Grain Co. v. Barge FBL-585*,[26] the Court held that the distinction between in rem and in personam actions did not affect the lower court's power to transfer an admiralty action to another forum in the interests of justice and convenience to the parties. In short, the Court severely limited in rem and quasi in rem jurisdiction as a means of circumventing the more formal notice requirements for in personam jurisdiction. At this stage, in rem and quasi in rem jurisdiction no longer stood rooted in *Pennoyer's* territorial power theory.[27] The Court thus

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ring) (stating that the Pennsylvania foreign attachment statute purporting to establish quasi in rem jurisdiction over debts owed to a resident garnishee was invalidated by *International Shoe's* "minimum contacts" standard); Camire v. Scieszka, 358 A.2d 397, 399 (N.H. 1976) (applying in personam test to invalidate quasi in rem jurisdiction over an automobile liability insurance policy).

23. *See, e.g.*, Hazard, *A General Theory of State-Court Jurisdiction*, 1965 SUP. CT. REV. 241, 281; Von Mehren & Trautman, *Jurisdiction to Adjudicate: A Suggested Analysis*, 79 HARV. L. REV. 1121, 1178 (1966); Traynor, *Is This Conflict Really Necessary?*, 37 TEX. L. REV. 657, 660-61 (1959); Ehrenzweig, *The Transient Rule of Personal Jurisdiction: The "Power" Myth and Forum Conveniens*, 65 YALE L.J. 289, 312-14 (1956).

24. 371 U.S. 208 (1962). *See also*, Walker v. City of Hutchinson, 352 U.S. 112 (1956) (holding newspaper publication notice of condemnation proceedings alone did not comply with due process requirements because the condemnor could have given personal notice by consulting official records); Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950) (holding that sufficiency of notice under procedural due process does not depend upon distinctions between actions in rem and in personam).

25. 371 U.S. at 211.

26. 364 U.S. 19 (1960). The Court held that an in personam action against the barge owner and an in rem action against the barge are one civil action for purposes of transfer under 28 U.S.C. § 1404(a). *Id.* at 27. The Court also held that whether an action is classified as in personam or in rem, the measure of "[a] man's liability for a demand against him is . . . the amount of property that may be taken from him to satisfy that demand." *Id.* at 24. *See also*, 371 U.S. at 213.

27. *Cf.* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 59, Comment a (1971) (possible inconsistency between principle of reasonableness which underlies field of judicial jurisdiction and traditional rule of in rem jurisdiction based solely on land in the state); *id.* § 60, Comment a (same as to jurisdiction based solely on

faced the choice of continuing *Pennoyer's* territorial power "myth" or abandoning *Pennoyer* and embracing some form of minimum contacts analysis for in rem and quasi in rem jurisdiction.

III. THE INSTANT DECISION

In the instant case the Court began by tracing the history of jurisdiction from *Pennoyer* through *International Shoe.*[28] The Court then noted that several well-reasoned lower court opinions and several commentators had advocated application of *International Shoe's* minimum contacts theory to in rem and quasi in rem jurisdiction questions.[29] The Court found that its procedural due process decisions regarding in rem and quasi in rem jurisdiction had impaired the remaining vitality of *Pennoyer.*[30] Thus, the instant Court stated the issue as "whether the standard of fairness and substantial justice set forth in *International Shoe* should be held to govern actions in rem as well as in personam."[31] According to the Court, "[t]he phrase, 'judicial jurisdiction over a thing,' is a customary eliptical way of referring to jurisdiction over the interests of persons in a thing."[32] The Court noted that in some cases the presence of property in the jurisdiction might provide sufficient minimum contacts among the forum state, the defendant, and the litigation.[33] The Court found that even though in rem actions and

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chattel in state); *id.* § 68, Comment c (rule of *Harris v. Balk* "might be thought inconsistent with the basic principle of reasonableness").

28. 97 S. Ct. at 2576-80.

29. *Id.* at 2580-81. *See* notes 26 & 27 *supra.* Both the courts and the commentators argue that a judgment in rem or quasi in rem directly affects the owner of that property. *Pennoyer,* on the other hand, held that in rem and quasi in rem judgments affected the property owner only indirectly.

30. 97 S. Ct. at 2581. The Court had previously held that property could not be subjected to a court's jurisdiction unless "reasonable and appropriate efforts" had been made to give property owners actual notice and that "Fourteenth Amendment rights cannot depend on the classification of an action as in rem or in personam." *See* notes 24 & 26 *supra.*

31. 97 S. Ct. at 2581. The Court uses the term in rem to indicate actions traditionally separated into in rem and quasi in rem.

32. *Id., quoting* RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 56, introductory note. The Court also referred to a statement made by Mr. Justice Holmes in *Tyler v. Court of Registration,* 175 Mass. 71, 76, 55 N.E. 812, 814, *appeal dismissed,* 179 U.S. 405 (1900). "All proceedings, like all rights, are really against persons. Whether they are proceedings or rights *in rem* depends on the number of persons affected." 97 S. Ct. 2581 n.22.

33. *Id.* at 2582. The Court stated that "when claims to the property itself are the source of the underlying controversy between the plaintiff and the defendant [this category of cases includes true in rem actions and the first type of quasi in

quasi in rem actions of this type[34] might be unaffected by applying the *International Shoe* standard, quasi in rem actions that sought to affect a defendant's property totally unrelated to the cause of action[35] would change dramatically when the minimum contacts standard was applied. The instant Court found that *Harris v. Balk*[36] best represented the case in which mere presence of the property would not establish sufficient minimum contacts.[37] It rejected the traditional justification that quasi in rem jurisdiction prevents wrongdoers from placing their assets in a forum where they are not subject to in personam jurisdiction.[38] Such an escape could be prevented by other means, the Court reasoned, since the property in the forum could be attached pending adjudication of an action in another forum which had in personam jurisdiction and since the full faith and credit clause would give a plaintiff with an in personam judgment the right to reach the wrongdoer's property wherever located.[39] The Court also rejected the justification that

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rem proceedings], it would be unusual for the State where the property is located not to have jurisdiction." *Id.* The Court listed several factors indicating sufficient minimum contacts: (1) defendant's usually expect to derive some benefit from the state's protection of their property interests, (2) the state's strong interests in property marketability within its borders and in procedures for peaceful resolution of property possession disputes, and (3) the likelihood that important records and witnesses will be found in the state. *Id.*

34. *See* note 10 *supra.*

35. *Id.* The Court noted that the Delaware statute in the instant case used quasi in rem jurisdiction over the defendants' stock and stock options to coerce them to submit to personal jurisdiction. 97 S. Ct. at 2585.

36. *See* note 13 *supra.*

37. The Court observed that *Harris* represents an indirect assertion of jurisdiction in a case where direct assertion of jurisdiction would likely violate the Constitution. Consequently, it would appear that such an indirect assertion is also unconstitutional. *Id.* at 2583.

38. This justification appears in RESTATEMENT (SECOND) OF CONFLICTS OF LAWS § 66, Comment a, as follows: "[a wrongdoer] should not be able to avoid payment of his obligation by the expedient of removing his assets to a place where he is not subject to an in personam suit." *Accord,* Stevenson, *supra* note 14, at 955.

39. 97 S. Ct. at 2583. The justification based on the absconding wrongdoer does not explain why in rem jurisdiction should be recognized even when property has not been placed in the forum to avoid claims elsewhere; it also does not explain jurisdiction to adjudicate the underlying claim. The justification may support attachment of the property as security for satisfaction pending adjudication in a forum satisfying the *International Shoe* standard. *Id. See, e.g.,* Von Mehren & Trautman, *supra* note 23, at 1178; Hazard, *supra* note 23, at 284-85; Beale, *The Exercise of Jurisdiction In Rem to Compel Payment of A Debt,* 27 HARV. L. REV. 107, 123-24 (1913).

in rem jurisdiction "avoids the uncertainty inherent in the *International Shoe* standard and assures a plaintiff of a forum."[40] The Court found that the *International Shoe* standard is easily applied to most cases and that "simplifying the litigation by avoiding the jurisdictional question" is too costly since it "may . . . sacrifice . . . 'fair play and substantial justice.' "[41] The Court expressly reserved judgment, however, on the question of "whether the presence of a defendant's property in a State is a sufficient basis for jurisdiction when no other forum is available to the plaintiff."[42] Finally, the Court found that long acceptance[43] of quasi in rem jurisdiction no longer cured the due process deficiencies since "continued acceptance would serve only to allow state court jurisdiction that is fundamentally unfair to the defendant."[44] Relying on the principle of "fundamental fairness" and its own rejection of traditional rationales supporting in rem and quasi in rem jurisdiction, the instant Court held that "all assertions of state court jurisdiction must be evaluated according to the standards set forth in *International Shoe* and its progeny."[45] The Court suggested that such a holding might be determinative since the Delaware courts had expressly held that the Delaware statute was not a "minimum contacts" statute.[46] The instant Court nevertheless proceeded to examine whether under a minimum contacts standard sufficient contacts existed to give Delaware jurisdiction.[47] It rejected the argument that the stock and stock options in Delaware were sufficient minimum contacts since the property was "not the subject matter of this litigation, nor is the underlying cause of the action related to the property."[48] The instant Court found no allegations

40. 97 S. Ct. at 2584 (citing Folk & Moyer, *supra* note 5, at 767).

41. 97 S. Ct. at 2584.

42. *Id.* at 2584 n.37.

43. *See* Pennington v. Fourth National Bank, 243 U.S. 269, 271 (1917) (fourteenth amendment does not abridge a state's in rem or quasi in rem jurisdiction); Harris v. Balk, 198 U.S. 215 (1905).

44. 97 S. Ct. at 2584. The Court stated that: " '[T]raditional notions of fair play and substantial justice' can be as readily offended by the perpetuation of ancient forms that are no longer justified as by the adoption of new procedures that are inconsistent with the basic values of our constitutional heritage." *Id.*

45. *Id.* at 2584-85. The Court did not expressly overrule any of the quasi in rem or in rem cases following *Pennoyer* and *Harris* but stated: "To the extent that prior decisions are inconsistent with this standard [the *International Shoe* standard], they are overruled." *Id.* at 2585 n.39.

46. 361 A.2d at 229. *See* 97 S. Ct. at 2588 (Brennan, J., concurring and dissenting).

47. *Cf.* 97 S. Ct. at 2588 (Brennan, J., concurring and dissenting).

48. 97 S. Ct. at 2585.

in the record that defendants had set foot in Delaware nor that any acts related to plaintiff's cause of action took place in Delaware. The Court refused to find sufficient contacts from defendant's positions as officers of a Delaware-chartered corporation despite plaintiff's argument that the state had a strong interest in supervising the management of Delaware corporations.[49] The Court rejected this argument because the Delaware legislature had not expressly stated this interest in passing the sequestration statute and because the statute in fact failed to reach all persons owing a fiduciary duty to Delaware corporations. The instant Court further found that Delaware had not statutorily required consent to jurisdiction in the state as a prerequisite to accepting a position as an officer of a Delaware corporation.[50] The Court then reasoned that an individual buying securities in a forum-chartered corporation did not impliedly consent to that forum's jurisdiction on every potential cause of action.[51] Thus, the instant Court held that even if the Delaware courts had construed the statute to incorporate the *International Shoe* standard, no sufficient minimum contacts existed in the instant case to allow jurisdiction. The two concurring opinions agreed that *International Shoe* was now the only constitutional standard for jurisdiction but argued that sufficient minimum contacts always exist when the plaintiff seeks to exercise in rem or quasi in rem jurisdiction over real property located in the forum.[52] One concurring Justice suggested that while implied consent would not be found in the case of a domestic purchaser of the securities of a domestic corporation, implied consent to the chartering forum's jurisdiction might be found in the case of an alien purchaser of the securities of a domestic corporation.[53] The lone dissenting Justice (concurring in part) accused the majority of rendering an advisory opinion because the highly factual considerations necessary to an evaluation of minimum contacts were not

49. The plaintiff argued that Delaware's courts should have had jurisdiction over corporate fiduciaries to protect this strong interest derived "from the role of Delaware's law in establishing the corporation and defining the obligations owed to it by its officers and directors." *Id.* at 2585.

50. Many states have so provided by statute. *See, e.g.,* CONN. GEN. STAT. § 33-322 (1977); N.C. GEN. STAT. § 55-33 (1973); S.C. CODE § 33-5-70 (1975).

51. 97 S. Ct. at 2586 (citing Folk & Moyer, *supra* note 5, at 785).

52. 97 S. Ct. at 2587-88 (Powell, J., Stevens, J., both concurring).

53. *Id.* at 2587 (Stevens, J., concurring). Justice Stevens justifies the implied consent doctrine on the ground that "a foreign investment is sufficiently unusual to make it appropriate to require the investor to study the ramifications of his decision." *Id.*

developed in the record[54] and the hypothetical constitutional question "decided" by the majority would affect the jurisdictional laws of all fifty states. The dissenter found two adequate bases to support jurisdiction in the instant case, assuming that the Delaware statute had incorporated the minimum contacts standard. First, the dissenting Justice found that Delaware had three strong state interests justifying jurisdiction over the shareholder's derivative action: (1) "a substantial interest in providing restitution for its local corporations that allegedly have been victimized by fiduciary misconduct, even if the managerial decisions occurred outside the state;" (2) a manifest regulatory interest over the conduct of corporate fiduciaries; and (3) "a recognized interest in affording a convenient forum for supervising and overseeing the affairs of an entity that is purely the creation of that State's law."[55] Secondly, the Justice stated that the distinctions between choice-of-law and jurisdiction issues should be minimized because another forum would "feel less knowledgeable and comfortable in interpretation, and less interested in fostering the policies of that foreign jurisdiction, than would the courts established by the State that provides the applicable law."[56]

IV. COMMENT

The instant case holding may seriously affect two facets of transnational law. First, American plaintiffs may find it very difficult to litigate non-federal, non-admiralty claims against alien defendants in any state forum. Many aliens have no direct business contacts with the various states other than property holdings. Those holdings often include savings accounts in commercial banks, real estate holdings, securities holdings in American business entities, and investment interests in leased equipment. Often these investor-aliens buy the property interests through American agents with all negotiations occurring in the alien's home country. Therefore all direct contacts between the alien and the United States property interests occur outside any possible United States

54. The trial court did not adequately examine the sufficiency of minimum contacts because neither the plaintiff nor the court considered that question relevant. 97 S. Ct. at 2589 (Brennan, J., concurring and dissenting).

55. *Id.* at 2590. Mr. Justice Brennan expressly limits jurisdiction based on these interests to shareholder's derivative actions.

56. *Id.* at 2591. *See, e.g.,* Gulf Oil Corp. v. Gilbert, 330 U.S. 501, 509 (1947); RESTATEMENT (SECOND) OF CONFLICTS OF LAW § 313 (1971); Traynor, *supra* note 23, at 664.

forum. Prior to the instant case, a United States plaintiff could have invoked quasi in rem jurisdiction over an alien's United States property interest in a given forum to satisfy his claim against the alien. Under the instant holding, a United States plaintiff cannot reach the alien's United States property unless minimum contacts are established between the alien defendant, some United States forum, and the underlying claim. If the alien's only contact is a property interest acquired through negotiations carried on outside of the United States, sufficient minimum contacts probably will not exist in any state. Nevertheless, such a result may promote the best general policy. Even though the forum state has a strong interest in providing a convenient forum for its plaintiff-residents' causes of action, forcing the alien to defend a suit far from his home solely because of an unrelated property interest in the forum may be fundamentally unfair. The instant holding thus might increase foreign investment in this country because foreign investors could purchase property interests without fear of being subjected to expensive civil litigation unrelated to the property interest. Conversely, the majority's opinion clearly reserved judgment on whether the presence of a defendant's property in a state is a sufficient basis for jurisdiction when no other forum is available to the plaintiff. Thus, in the above hypothetical where the plaintiff has no forum for his claim against an alien without United States contacts save a property interest, the court might hold that the property interest is sufficient to establish jurisdiction. Alternatively the court might follow Justice Stevens' concurring opinion suggesting that an alien purchaser of securities, as opposed to a domestic purchaser, should be charged with a higher degree of notice that he may be subject to jurisdiction of the courts in the home forum of the corporation issuing the purchased securities. The primary obstacle to such a rule would be the equal protection argument that jurisdictional discrimination between property interest owners based on alienage violates the fourteenth amendment.[57]

The second facet of transnational law directly affected by the instant holding is admiralty in rem jurisdiction. Admiralty in rem

57. *See, e.g.*, Graham v. Richardson, 403 U.S. 365 (1971) (holding state laws denying welfare benefits to aliens violate the fourteenth amendment because alienage classifications are inherently suspect); Hampton v. Mow Sun Wong, 426 U S. 88 (1976) (holding unconstitutional a federal Civil Service Commission regulation barring resident aliens from employment in the federal competitive civil service).

jurisdiction acts directly on the vessel to enforce a maritime lien arising from "certain mishaps or the non-fulfillment of certain obligations arising out of contract or status."[58] In rem admiralty actions to enforce maritime liens may only be brought in federal district courts.[59] An in rem admiralty complaint must state that the vessel is in or will be in the district during the pendency of the action.[60] Process for in rem admiralty actions may be served only within the district in which the complaint is filed.[61] The effect of these two provisions is that an in rem admiralty action may be brought only in the district where the vessel is found. The holding in the instant case indicates, however, that mere presence of property is no longer a prima facie sufficient jurisdictional basis. If the courts apply the *International Shoe* standard to admiralty in rem jurisdiction, such jurisdiction may lose its vitality. Since the in rem action may be be brought only in the district where the property is found, and in many cases the owner of the vessel may have no contacts with the district forum where the vessel comes to rest except the mere physical presence of the property, an in rem action could not be brought in any district.[62] A similar problem arises in the case of an alien-owned vessel. If the alien has no business or other contacts with the United States other than the presence of his vessel, the court may hold there are no sufficient minimum contacts to maintain admiralty in rem jurisdiction anywhere. Nevertheless, there are three means by which the court might in the future avoid this result. First, the court could uphold admiralty in rem jurisdiction in the district where the vessel is located when a failure to do so would leave the plaintiff without any forum.[63] Second, the court might charge an alien vessel owner with a higher degree of notice that his vessel might be subject to jurisdiction in

58. G. GILMORE & C. BLACK, THE LAW OF ADMIRALTY 35, 36 (2d ed. 1975).

59. *Id.* at 38. *See* The Moses Taylor, 71 U.S. 411 (1867) (striking down a California statute conferring on the state courts power to administer in rem proceedings against vessels).

60. FED. R. CIV. P., SUPPLEMENTAL RULES FOR CERTAIN ADMIRALTY AND MARITIME CLAIMS, Rule C(2).

61. *Id.* at Rule E(3)(a).

62. This is true whenever the vessel's owner does not have sufficient minimum contacts with the forum where the vessel is located. If the court employs "personification" of the vessel to adjudicate the in rem action, however, perhaps the minimum contacts standard would apply to the personified vessel rather than to her owner. *See* G. GILMORE & C. BLACK, *supra* note 58, at 616.

63. The Court in the instant case expressly reserved the question "whether presence of a defendant's property in a state is a sufficient basis for jurisdiction when no other forum is available to the plaintiff." 97 S. Ct. at 2584 n.37.

any foreign forum within which his vessel came to rest. However, just as with the alien purchaser of securities, a higher standard of notice based on alienage might violate the fifth amendment.[64] Finally, the court might hold that minimum contacts in this context means aggregate minimum contacts with the United States as a whole. In *Cryomedics, Inc. v. Spembly, Ltd.*,[65] the court held that "a federal court may properly exercise in personam jurisdiction over an alien defendant in a suit arising from federal law if the alien's aggregate contacts with the United States satisfy the due process requirements of the fifth amendment . . . ."[66] The *Cryomedics* case allows a plaintiff to sue an alien defendant in any federal district court as long as the alien has sufficient aggregate minimum contacts with the United States. Therefore, if an admiralty in rem action is a federal question and if the alien defendant has "aggregate" minimum United States contacts, the plaintiff may sue in the district where the vessel is located even though the alien does not have sufficient minimum contacts with that district under the normal *International Shoe* standard.[67] Admiralty actions are not normally federal questions for purposes of federal court jurisdiction,[68] but since in rem admiralty actions can be brought only in federal district courts, plaintiffs should receive the benefits of the *Cryomedics* federal question aggregate contacts test. If *Cryomedics* is applied, American plaintiffs will be assured a forum for their in rem admiralty actions in spite of the instant holding.

Thomas E. Settles

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64. *See* note 57 *supra* regarding alienage classifications as violations of the fourteenth amendment.

65. 397 F. Supp. 287 (D. Conn. 1975), *noted at* 9 VAND. J. TRANSNAT'L L. 435, 436 (1976).

66. *Id.*

67. As differentiated from the *Cryomedics* aggregate contacts test.

68. Romero v. International Terminal Operating Co., 358 U.S. 354 (1959).

SECURITIES REGULATIONS—EXTRATERRITORIAL APPLICATION OF THE ANTIFRAUD PROVISIONS—FEDERAL SECURITIES LAWS GRANT JURISDICTION WHEN THERE IS SOME ACTIVITY IN FURTHERANCE OF A FRAUDULENT SCHEME COMMITTED WITHIN THE UNITED STATES

I. FACTS AND HOLDING

The Securities and Exchange Commission (SEC) brought suit for injunctive relief against nine individual and corporate defendants, alleging violations of the antifraud provisions of the Securities and Exchange Acts of 1933 and 1934.[1] According to the SEC, the Manitoba Development Fund (MDF), a Canadian corporation wholly owned by the Province of Manitoba, Canada,[2] was fraudulently induced to invest in debt securities issued by Churchill Forest Industries (CFI), a Canadian corporation with offices in New Jersey, and River Sawmill Company (River), a Delaware corporation.[3] Under financial agreements between the parties,[4] the financing by MDF was contingent upon both CFI and River providing substantial amounts of their own equity capital.[5] The SEC contended that defendants never intended to make the agreed upon equity contribution, that funds supplied by MDF were represented as defendants' equity participation, and that these and subsequent funds were used for the personal benefit of defendants and in violation of the investment contract.[6] The defendants argued that the

1. Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a)(1970); Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78j(b)(1970); 17 C.F.R. § 240.10b-5 (1976).

2. MDF was established by the provincial government of Manitoba for the purpose of developing a forestry complex at Pas, Manitoba.

3. Defendant Alexander Kasser, a United States citizen, allegedly owned and controlled both CFI and River. Kasser was never served with process in the present action.

4. The finance agreement between CFI and MDF was "partially negotiated" in New York but executed in Canada. SEC v. Kasser, 391 F. Supp. 1167, 1169 (D.N.J. 1975). According to the district court, Kasser and other defendants "caused" River to enter into the finance agreement with MDF in Montclair, New Jersey. *Id.* at 1171. Apparently, this is the finance agreement the district court and the appellate court refer to as "executed in New York." *See* note 7 *infra.*

5. The finance agreements defined equity capital as "money paid in cash for shares of C.F.I. stock and expressly excluded the use of retained earnings and government grants under the so-called Canadian Area Development Incentive Act." 391 F. Supp. at 1169. As MDF authorized loan disbursements for the project, CFI and River would in turn issue debenture certificates to MDF. *Id.* at 1170. A total of approximately $45 million was invested by MDF.

6. The agreements stipulated that the funds were to be used solely for the development of a forestry complex. In 1970, both CFI and River defaulted on their interest payments. Subsequently, a receivership action was instituted and MDF

district court lacked subject matter jurisdiction because the case involved a foreign transaction and the only injury was to a foreign party. While conceding the absence of any effect within the United States, the SEC argued that courts have jurisdiction under the Securities and Exchange Acts when a scheme to defraud a foreign entity is devised by Americans in the United States and instrumentalities of interstate commerce are used in furtherance of such a scheme. The district court dismissed the complaint, stating that the securities laws were enacted to protect domestic investors and securities markets and that the "miscellaneous acts"[7] of defendants allegedly committed in the United States did not alter the essentially foreign nature of the transaction.[8] On appeal to the United States Court of Appeals for the Third Circuit, *reversed. Held:* Federal securities laws grant jurisdiction when there is some activity in furtherance of a fraudulent scheme committed within the United States.[9] *SEC v. Kasser,* 548 F.2d 109 (3d Cir. 1977).

II. LEGAL BACKGROUND

The Securities and Exchange Acts are silent as to the intended jurisdictional reach of the antifraud provisions. In *Schoenbaum v. Firstbrook,*[10] the court ruled that Congress intended the Securities

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was awarded the companies' remaining assets by the Court of Queens Bench in November, 1973. *Id.* at 1172.

7. The miscellaneous acts occurring within the United States were summarized as follows:

(1) meetings were held in the United States as part of negotiations;
(2) a New York office of the Swiss Bank Corporation was used as a conduit for the transfer of funds, although only a relatively small portion of those funds was actually so transferred through that bank;
(3) one Master Finance Agreement was executed in New York;
(4) defendants incorporated most of the corporations in this country and discussed their plans in New Jersey; and
(5) the means of interstate commerce (mails, telephone and telegraph) were employed in furtherance of the scheme.

Id. at 1176.

8. *Id.*

9. To the findings of the district court with respect to defendants' activity within the United States, the court of appeals added the following acts: "(1) maintenance of books and records in the country; (2) drafting of agreements executed elsewhere; and (3) transmittal of proceeds from the transactions to and from the United States." SEC v. Kasser, 548 F.2d 109, 111 (3d Cir. 1977).

10. 405 F.2d 200 (2d Cir. 1968) (American shareholders of a Canadian corporation listed on an American exchange brought suit claiming fraud in the sale of the corporation's stock to another Canadian corporation). *Schoenbaum* actually overruled an earlier New York district court decision, Ferraioli v. Cantor, [1964-

and Exchange Acts to have extraterritorial application when necessary "to protect domestic investors who have purchased securities on an American exchange and to protect the domestic securities market from the effects of improper transactions in American securities."[11] Under the ruling in *Schoenbaum,* even if all the alleged violations of the antifraud provisions occur outside the United States, federal courts have subject matter jurisdiction if the transaction involves stock registered on an American exchange and is detrimental to American investors.[12] In *Leasco Data Processing Equipment Corp. v. Maxwell,*[13] the court suggested that detrimental effects on American investors resulting from fraudu-

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1966 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 91,615, at 95,310 (S.D.N.Y. 1965), which had declined jurisdiction over an alleged fraud involving a private sale in Canada of a controlling interest in an American corporation traded on the New York Stock Exchange. The suit was brought by resident Americans who were minority shareholders.

11. 405 F.2d at 206. It is a canon of statutory construction that unless a contrary intent is apparent, congressional legislation is presumed to apply territorially. Foley Bros., Inc. v. Filardo, 336 U.S. 281 (1949); RESTATEMENT (SECOND) FOREIGN RELATIONS LAW OF THE UNITED STATES § 38 (1965). By declaring the purpose of the Securities and Exchange Acts to be the protection of American investors and domestic securities markets, the court in *Schoenbaum* circumvented this constructional obstacle to jurisdiction. According to principles of international law, a state may exercise jurisdiction over conduct outside the state's territory provided the conduct causes an effect within the state. RESTATEMENT (SECOND) FOREIGN RELATIONS LAW OF THE UNITED STATES § 18 (1965). *See also* United States v. Aluminum Co. of America, 148 F.2d 416 (2d Cir. 1945).

12. Schoenbaum v. Firstbrook, 405 F.2d at 208. The court noted, however, that should the alleged wrong constitute a cause of action under foreign law, jurisdiction might be declined under the doctrine of forum non conveniens. *Id.* at 209. The fraud allegedly committed by defendant was the sale of the corporation's stock at below market value. The effect on American shareholders was a reduction in their equity holding. In SEC v. United Financial Group, Inc., 474 F.2d 354 (9th Cir. 1973), the court upheld jurisdiction over an American defendant who attempted to limit the sale of securities solely to foreigners. Because three Americans with foreign residences had purchased $10,000 of the securities, the court found sufficient effects upon American investors. In Bersch v. Drexel Firestone, Inc., 519 F.2d 974, 989 (2d Cir. 1975), the court stated that from a jurisdictional standpoint there must be injury to a purchaser or seller in whom the United States has an interest as opposed to general effects on the American economy or investing public. In IIT v. Vencap, Ltd., 519 F.2d 1001, 1016-17 (2d Cir. 1975), the court doubted whether the effects on American shareholders, who represented only .2% of IIT's fundholders and at most .5% of the total investment, would be substantial enough for purposes of jurisdiction.

13. 468 F.2d 1326 (2d Cir. 1972) (an American corporation claimed it was fraudulently induced by British companies and individuals to purchase shares of a British company listed on a British stock exchange).

lent acts committed abroad would be insufficient for jurisdictional purposes where the transaction involved foreign securities not traded on an American securities market.[14] The court, however, found alternative grounds for exercising jurisdiction. Referring to section 17 of the *Restatement (Second) of Foreign Relations Law of the United States,*[15] the court stated that conduct alone within a state is valid grounds upon which to base jurisdiction.[16] The *Leasco* court upheld jurisdiction because defendants' conduct within the United States was an "essential link" in the fraudulent scheme.[17] The extent and nature of conduct within the United States necessary to meet the jurisdictional threshold in transnational transactions was not clearly settled in *Leasco.* In *Wandschneider v. Industrial Incomes, Inc. of North America,*[18]

14. *Id.* at 1334. "When no fraud has been practiced in this country and the purchase or sale has not been made here, we would be hard pressed to find justification for going beyond *Schoenbaum.*" *Id.*

15. Section 17 provides:

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

Although part (b) of § 17 seems to limit the applicability of part (a), the court cited comment (b) as justification for the inference that conduct alone is sufficient. Comment (b) reads as follows:

> X and Y are in state A. X makes a misrepresentation to Y. X and Y go to state B. Solely because of the prior misrepresentation, Y delivers money to X. A has jurisdiction to prescribe a criminal penalty for obtaining money by false pretenses.

16. The court recognized, however, that whether Congress intended to extend jurisdiction upon this basis depends on the interpretation of the particular statute. According to Judge Friendly in *Leasco,* Congress intended the securities laws to cover situations where misrepresentations with respect to any securities were made to Americans in the United States. Leasco Data Processing Equip. Corp. v. Maxwell, 468 F.2d at 1335-37. The practice of basing subject matter jurisdiction under the securities laws on conduct within the United States was recognized before *Leasco. See, e.g.,* Investment Properties Int'l, Ltd. v. I.O.S., Ltd., [1970-1971 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,011 at 90,726 (S.D.N.Y. 1971); Finch v. Marathon Sec. Corp., 316 F. Supp. 1345 (S.D.N.Y. 1970).

17. 468 F.2d at 1335. After concluding that abundant misrepresentations were made in the United States, the court added, "[b]eyond this we see no reason why, for purposes of jurisdiction to impose a rule, making telephone calls and sending mail to the United States should not be deemed to constitute conduct within it." *Id.*

18. [1971-1972 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 93,422 at 92,054 (S.D.N.Y. 1972) (suit brought by West German resident against American corpo-

which involved the fraudulent sale of stock to a West German resident, the court stated that subject matter jurisdiction obtains whenever a scheme of misrepresentation is devised by United States residents within the United States and the mails are used in furtherance of such scheme.[19] The test used by the Eighth Circuit in *Travis v. Anthes Imperial, Ltd.*[20] was whether significant conduct with respect to the alleged fraud had taken place in the United States.[21] If misrepresentations are made through the mails or other instrumentalities of interstate commerce, there is sufficient conduct, regardless of which party initiated such use.[22] In *Bersch v. Drexel Firestone, Inc.*,[23] the Second Circuit attempted to formulate more definitive guidelines for applying the antifraud provisions extraterritorially. As for losses to foreigners from the sale of securities outside the United States, the antifraud provisions do not apply unless the loss is directly caused by acts (or culpable failures to act) committed within the United States.[24]

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ration and individual for recovery of investment in stock not traded on any American exchange).

19. *Id.* at 92,065. Similar language is found in SEC v. Gulf Intercontinental Fin. Corp., 223 F. Supp. 987 (S.D. Fla. 1963) (jurisdiction upheld over various American corporations and individuals who organized a Canadian corporation for the purpose of issuing fraudulent debt securities) where the court stated:

> It would appear that where the scheme is one which necessarily must be accomplished in part by the use of the mails or interstate facilities within the limits of our federal jurisdiction that even though the offer [of securities was] made entirely outside the nation that the remedial protection of [sections 17(a) and 10(b)] may be invoked.

Id. at 995.

20. 473 F.2d 515 (8th Cir. 1973) (jurisdiction upheld in class action by American shareholders of Canadian corporation who claimed they were fraudulently induced to hold onto their stock during a tender offer until the market for the shares dissipated).

21. *Id.* at 524.

22. *Id.* at 526.

23. 519 F.2d 974 (2d Cir. 1975) (class action on behalf of purchasers of common stock of a Canadian corporation who claimed that the prospectus contained fraudulent misrepresentations).

24. *Id.* at 993. According to the court, the antifraud provisions of the federal securities laws:

> (1) apply to losses from sales of securities to Americans resident in the United States whether or not acts (or culpable failures to act) of material importance occurred in this country; and
>
> (2) apply to losses from sales of securities to Americans resident abroad if, but only if, acts (or culpable failures to act) of material importance in the United States have significantly contributed thereto; but
>
> (3) do not apply to losses from the sale of securities to foreigners outside

According to *Bersch,* when the injury is to a foreign party, the conduct of a defendant within the United States must include a substantial part of the fraud itself. Mere "preparatory activity" relatively slight in comparison to acts committed abroad, is not sufficient for jurisdiction.[25] Subsequent to *Bersch,* the Second Circuit in *IIT v. Vencap, Ltd.*[26] stated that Congress did not intend to allow the United States to be used as a haven for the manufacturing of fraudulent securities, even if only for export to foreigners.[27] At the same time, the court expressed a reluctance to apply securities laws whenever "something" has occurred in the United States.[28] According to *IIT,* the line must be drawn between conduct in the United States incident to a transnational transaction and conduct encompassing an element of the alleged fraud itself.[29] Although the rule established in *Bersch* and *IIT* was being followed by district courts in the Second Circuit,[30] the transnational scope of federal securities laws had not been decided in the other circuits.

III. THE INSTANT OPINION

In the instant case, the court ruled that the antifraud provisions of the securities laws apply whenever some activity in furtherance of a fraudulent scheme occurs in the United States.[31] In reaching its decision, the court first recognized that conduct alone within the United States can be grounds upon which to base jurisdiction under the securities laws.[32] The court cited language in the Acts as evincing a congressional intent for broad jurisdictional scope.[33]

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the United States unless acts (or culpable failures to act) within the United States directly caused such losses.

Id.

25. *Id.* at 987.

26. 519 F.2d 1001 (2d Cir. 1975) (an investment company incorporated in Luxembourg alleged fraudulent misrepresentation and misappropriation of equity investment on the part of Vencap, Ltd., a defunct Bahamian corporation, and an American resident abroad). *IIT* was decided the same day as *Bersch.*

27. *Id.* at 1017.

28. *Id.* at 1018.

29. *Id.*

30. *E.g.,* F.O.F. Proprietary Funds, Ltd. v. Arthur Young & Co., 400 F. Supp. 1219 (S.D.N.Y. 1975) (suit by Canadian corporation that had purchased unlisted American securities from a Luxembourg investment company against an accounting firm that had participated in drafting an allegedly fraudulent prospectus, dismissed for lack of subject matter jurisdiction).

31. 548 F.2d at 114.

32. *Id.* at 112-13.

33. *Id.* at 114.

Consequently, an impact in the United States is not a prerequisite to jurisdiction over transnational securities transactions. The court then adopted language from *IIT* stating that if Congress did not intend for this country to be used as a base for the manufacture and export of fraudulent securities, it did not intend to prohibit the SEC from policing such activity.[34] Since defendants' conduct in the United States in the present case entailed more than mere preparatory activity, the district court was wrong in relying on restrictive language in *IIT*.[35] Since the United States-based activities were "crucial" and "essential" to the accomplishment of the fraud, defendants failed to persuade the court that their activity was not the direct cause of the extraterritorial loss.[36] Therefore, the *Bersch* opinion did not stand in the way of exercising jurisdiction.[37] The court noted that exercising jurisdiction over American defendants who might otherwise be outside the reach of Canadian authorities would encourage reciprocal treatment of those in foreign countries who attempt to export fraudulent securities into the United States.[38] Thus, the SEC has subject matter jurisdiction under the antifraud provisions whenever some activity in furtherance of a fraudulent scheme occurs in this country.[39]

IV. COMMENT

Although the result reached by the Third Circuit is sound, the holding is unnecessarily broad. The court confronted an allegedly deliberate effort on the part of an American citizen to avoid federal law while using this country as an operating base for the export of fraudulent securities. Under these circumstances, the court appropriately recognized that the lack of a substantial impact in the United States does not necessarily prevent federal courts from exercising jurisdiction over transnational securities transactions. Further, international law permits jurisdiction over conduct occurring within a state. Whether Congress intended for a particular statute to so apply is, in the absence of clear statutory language, a

34. *Id.* at 112.
35. *Id.* at 114-15.
36. *Id.* at 115.
37. The court felt there was much more United States-based activity than in *Bersch,* including "the execution of a key investment contract in New York as well as the maintenance of records in this country by both American and foreign corporations . . . that were crucial to the consummation of the fraud." *Id.*
38. *Id.* at 116.
39. *Id.* at 114.

matter of judicial interpretation. The struggle in federal courts has been to draw the line between transnational transactions in which the United States has a bona fide interest and those where the American connection is tangential. This line has become increasingly difficult to draw as the national capital markets have been transformed into international marketplaces. Before reaching the jurisdictional issue in *IIT*, Judge Friendly emphasized "the importance of ascertaining as precisely as possible the exact means by which the fraud has been accomplished . . . ."[40] Unless this step is undertaken, it cannot be determined whether an element of the alleged fraud has occurred in the United States. Without that determination, it is unclear whether defendants' conduct within this country directly caused the extraterritorial loss.[41] Unless these threshold jurisdictional hurdles are erected, federal courts will become increasingly involved in transnational securities transactions of an essentially foreign nature. In the instant case, the court failed to make the necessary threshold determinations.[42] Instead, it summarized defendants' United States-based activity as "essential" and "crucial" to the fraudulent scheme. While the court's discussion suggests more is necessary, the holding simply requires some United States activity in furtherance of a scheme to defraud. This ruling could bring foreign transactions with only a peripheral United States connection under the jurisdiction of fed-

40. 519 F.2d at 1009. According to the court, jurisdictional and remedial issues may turn upon this.

41. This analytical framework was followed in F.O.F. Proprietary Funds, Ltd. v. Arthur Young & Co., 400 F. Supp. 1219. There the alleged fraud was in the sale of debentures and the communication of misleading information. Defendant's alleged role was in the drafting of offering circula which contained misrepresentations and omissions of material facts. Since the fraud consisted of the distribution of the offering circula and this occurred abroad, defendant's conduct in the United States was deemed preparatory, and not the direct cause of the loss.

42. Assuming the court had done so, it is still arguable whether or not its jurisdictional test could have been met. For example, if the execution in New York of one of the finance agreements was merely a memorialization of an agreement reached abroad, that itself might not constitute fraudulent conduct in the United States. *See* IIT v. Vencap, Ltd., 519 F.2d at 1006-08, 1011. On the other hand, if an essential element of the fraud was the ongoing misrepresentation of MDF funds as CFI and River equity investment, then the maintenance of records and the subsequent activity of defendants in the country would constitute an integral part of the fraud itself.

eral courts.[43] The Third Circuit should find it necessary to qualify and restrict its holding in the future.

John J. Gorman

43. The constitutionality of the distinction drawn by the Second Circuit between the jurisdictional prerequisites for losses to foreigners and losses to Americans at home and abroad has been questioned. Note, *American Adjudication of Transnational Securities Fraud,* 89 HARV. L. REV. 553, 569 (1976). Whether the distinction comports with United States treaty obligations is another question. According to the article, a more useful method would be to first determine why a defendant chose the United States as a situs for some fraud-related activity. If the United States was chosen to add credibility to the sale of the allegedly fraudulent securities, jurisdiction should obtain. *Id.* at 570.