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# Recent Cases

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# RECENT CASES

## Antitrust—*Noerr-Pennington* Immunity for Joint Efforts to Influence Governmental Action—Intent to Cause Competitive Injury, Evidenced by Repeated, Baseless Opposition Before an Adjudicatory Body, Does Not Result in Loss of *Noerr-Pennington* Immunity Absent Specific Allegations of Conduct External to or Abusive of the Adjudicatory Processes

### I. Facts And Holding

Plaintiffs, two subsidiaries of McDonald's Corporation,[1] brought suit in federal district court[2] claiming that defendants, a labor union and two associations of restaurant and hotel employers, had violated section 1 of the Sherman Act[3] by conspiring to oppose repeatedly, baselessly, and in bad faith a municipal board's approval of building permits for the construction of McDonald's restaurants.[4] Defendants asserted that their joint efforts to influence the board were immune from antitrust attack under the *Noerr-Pennington* doctrine[5] and moved to dismiss the complaint for failure to state a claim. Plaintiffs countered by contending that defendants' groundless opposition was designed to foreclose plaintiffs' access to the municipal board with the ultimate purpose of suppressing plain-

1. The two subsidiaries were Franchise Realty Interstate Corporation and McDonald's Systems of California, hereinafter referred to collectively as McDonald's.

2. The suit was filed in the United States District Court for the Northern District of California.

3. Section 1 provides in pertinent part: "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is declared to be illegal." 15 U.S.C. § 1 (1970).

4. Plaintiffs had applied for and been granted permits for the construction of three restaurants by the San Francisco Department of Public Works. Defendants successfully persuaded the San Francisco Board of Permit Appeals to overrule and deny the issuance of these permits pursuant to § 3.651 of the Charter of the City of San Francisco. This charter provision sets forth the functions, powers, and duties of the Board of Permit Appeals:

> [A]ny person who deems that his interests or property or that the general public interest will be adversely affected as a result of operations authorized by or under any permit or license granted or issued by any department may appeal to the board of permit appeals.

Defendants' conduct before this board of appeals forms the subject matter of the instant litigation.

5. The development of the *Noerr-Pennington* immunity is traced in section II of this Comment.

tiffs' activities as a competitor[6] and thus fell within the "sham exception" to the *Noerr-Pennington* defense. The trial court found that the alleged conduct enjoyed *Noerr-Pennington* immunity and granted the motion to dismiss.[7] On appeal to the United States Court of Appeals for the Ninth Circuit, *held*, affirmed. The bare allegation that repeated joint efforts to influence a governmental body are nothing more than a scheme to injure a competitor and to foreclose its access to an administrative agency does not state a claim under section 1 of the Sherman Act without further specific allegations of activities external to or abusive of the adjudicatory process that tend to harass and deter the competitor from having free and unlimited access to the agency. *Franchise Realty Interstate Corp. v. San Francisco Local Joint Executive Board of Culinary Workers*, 542 F.2d 1076 (9th Cir. 1976), *cert. denied*, 45 U.S.L.W. 3626 (U.S. Mar. 22, 1977) (No. 76-1023).

## II. LEGAL BACKGROUND

In *Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc.*,[8] the Supreme Court first conferred antitrust immunity on joint efforts to influence state legislatures and executives. In *Noerr* a number of long-distance trucking companies brought an antitrust action[9] against a group of railroads alleging that the defendants jointly had conducted a publicity campaign to secure passage and enforcement of laws favorable to the railroads and competitively disadvantageous to the trucking industry.[10] The Court held unanimously that the railroads' conduct was immune from antitrust

6. The additional relevant allegations of the complaint may be summarized as follows: defendants agreed to oppose every permit granted to plaintiffs by the Department of Public Works and to threaten withdrawal of political support for any Board member who voted to sustain issuance of permits to plaintiffs. Defendants knew their opposition to be groundless in that they were aware plaintiffs had complied with all relevant building requirements. Furthermore, defendants induced the Board to exceed its constitutional authority and to assume the improper role of an economic review board with the power to determine what competition would exist in San Francisco. 542 F.2d 1076, 1078 (9th Cir. 1976).

7. The trial court dismissed plaintiffs' first amended complaint without leave to amend under FED. R. CIV. P. 12(b)(6) and also denied plaintiffs' post-judgment motion for leave to file a second amended complaint, which the instant court described as adding nothing but adjectives to the first complaint, under FED. R. CIV. P. 15(a) and 50(b)(6).

8. 365 U.S. 127, *rehearing denied*, 365 U.S. 875 (1961).

9. The action was brougbt under § 1 of the Sherman Act, 15 U.S.C. § 1 (1970). 365 U.S. at 129.

10. Plaintiffs specifically alleged that defendants' campaign induced the Governor of Pennsylvania to veto the "Fair Truck Bill," wbicb would have allowed trucks to carry heavier loads on Pennsylvania highways. Plaintiffs further alleged that the campaign was calculated to impair the general reputation of the trucking industry and to dissuade customers from using trucking as a method of long-distance freight transportation. *Id.* at 130.

scrutiny, notwithstanding that the campaign was carried out for anticompetitive purposes, that it was conducted in a deceptive and unethical manner,[11] and that it was responsible for inflicting direct competitive injury unrelated to the passage or enforcement of laws.[12] Two main considerations formed the basis of the *Noerr* Court's rationale. First, the Court reasoned that since valid state action having an anticompetitive effect enjoys antitrust immunity,[13] joint efforts to induce the legislature or executive to take such action should have corresponding immunity.[14] Secondly, although the Court expressly declined to decide whether the first amendment right to petition encompassed joint lobbying efforts, the Court found no mandate in the legislative history of the antitrust laws to impute to the Sherman Act a purpose to regulate conduct that was at least arguably protected by the first amendment.[15] The Court noted, however, that its ruling was limited to "genuine efforts" to influence governmental action and would not extend to a publicity campaign that was "a mere sham to cover what is actually nothing more than an attempt to interfere directly with the business relationships of a competitor."[16]

The antitrust immunity conferred in *Noerr* was reinforced and expanded in *United Mine Workers v. Pennington*.[17] In *Pennington* a small coal company alleged that a labor union had conspired with a number of large coal producers to persuade the Secretary of Labor to set high minimum wages for the companies from which the Ten-

11. The railroads hired a public relations firm to generate seemingly spontaneous statements from fictitious public interest groups. *Id.* at 129-30.

12. In this regard the Court noted:

> It is inevitable, whenever an attempt is made to influence the legislation by a campaign of publicity, that an incidental effect of that campaign may be the infliction of some direct injury upon the interests of the party against whom the campaign is directed. And it seems equally inevitable that those conducting the campaign would be aware of, and possibly even pleased by, the prospect of such injury. To hold that the knowing infliction of such injury renders the campaign itself illegal would thus be tantamount to outlawing all such campaigns.

*Id.* at 143-44.

13. *See* Parker v. Brown, 317 U.S. 341 (1943); United States v. Rock Royal Co-op., 307 U.S. 533 (1939).

14. The thrust of this argument was that the unrestricted flow of ideas, even if deceptively or unethically presented, was vital to the proper functioning of representative government.

15. Underlying both aspects of the Court's analysis was the belief that the central concern of the Sherman Act was "business activity" such as price-fixing, market division, and boycotts. Defendants' "political activity" was so "essentially dissimilar" to the traditional Sherman Act offenses that although the conduct was clearly reprehensible, it simply fell outside the scope of Congress' antitrust policy. 365 U.S. at 136-37.

16. *Id.* at 144.

17. 381 U.S. 657 (1965).

nessee Valley Authority purchased coal and to induce the TVA itself to curtail its practice of making spot purchases of coal from small coal producers. Although recognizing the union's anticompetitive purpose, the Court extended the *Noerr* immunity to include joint attempts to influence the policy decisions of public officials as well as joint efforts to lobby for the passage and enforcement of statutes.

After *Noerr* and *Pennington* the question remained whether the antitrust immunity for joint efforts to influence governmental policy making applied with equal force to efforts to secure favorable rulings from administrative and judicial bodies. In California a district court dismissed a complaint[18] in which a group of trucking companies alleged that a group of competing highway carriers had pooled financial resources in order to fund a program of continual, indiscriminate opposition to the plaintiffs' applications for operating rights before the California Public Utilities Commission and the Interstate Commerce Commission.[19] The trial court held that the *Noerr-Pennington* immunity was fully operative in the adjudicative setting. Reaching the opposite conclusion, the Ninth Circuit reversed[20] and declared that the *Noerr-Pennington* immunity was inapplicable to efforts to influence the administrative process. Finally, the Supreme Court resolved the dispute in *California Motor Transit Co. v. Trucking Unlimited.*[21] Echoing *Noerr's* concern for preserving the flow of information from citizens to the government and for protecting first amendment rights,[22] the Court concluded that the same rationale safeguards the access of citizens to administrative agencies.[23] Although approving the district court's extension of the *Noerr* immunity to adjudicatory proceedings, the Court affirmed the Ninth Circuit's order remanding the case for trial on the grounds that the plaintiffs' allegations came within the *Noerr* "sham" exception as adapted to the adjudicatory context.[24] The exact line of reasoning by which the Court reached this conclusion is difficult to reconstruct. Central to the Court's argument, however, was the notion that whereas unethical conduct in the "political

18. Trucking Unlimited v. California Motor Transport Co., 1967 Trade Cas. ¶ 72,298 (N.D. Cal. 1967).

19. Plaintiffs also alleged that in order to deny plaintiffs' access to the administrative process, defendants instituted proceedings regardless of prohable cause and the merits of the cases and that defendants publicized their scheme generally and communicated threats of continued opposition directly to plaintiffs.

20. 432 F.2d 755 (1970).

21. 404 U.S. 508 (1972).

22. *See* notes 13-15 *supra* and accompanying text.

23. 404 U.S. at 510.

24. *Id.* at 516.

arena" is clearly immunized from antitrust attack under *Noerr*, "reprehensible practice[s] . . . may corrupt the administrative or judicial processes and . . . may result in antitrust violations."[25] The Court gave as examples of such activities fraudulent procurement of a patent, conspiracy with a licensing authority, and bribery of a public purchasing agent. By analogy to these transgressions, the Court suggested that a pattern of baseless, repetitive claims that barred a competitor's access to an administrative agency or court would constitute an abuse of the adjudicatory process actionable under the Sherman Act.[26]

The Court's most recent reference to the *Noerr-Pennington* immunity came in *Otter Tail Power Co. v. United States*.[27] In that case the government alleged that the defendant public utility company attempted to retain its monopoly by filing a series of lawsuits in order to prevent several municipalities, which formerly had purchased electrical power from the utility at retail, from establishing their own retail electrical systems. Although the utility eventually lost all the litigation that it initiated, the pendency of the suits interfered with the municipalities' efforts to market revenue bonds to raise money for their systems.[28] The district court, in a decision filed prior to the Supreme Court's disposition of *Trucking Unlimited*, found that the utility's conduct was subject to antitrust scrutiny because the trial court believed that *Noerr* did not insulate

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25. *Id.* at 513.

26. Although the Court's opinion specifically referred to the "access-barring" and "indiscriminate opposition" language of the complaint, the Court noted:

> More critical are other allegations, which are too lengthy to quote, and which elaborate on the "sham" theory by stating that the power, strategy, and resources of the petitioners were used to harass and deter respondents in their use of administrative . . . proceedings . . . .

*Id.* at 511. Ostensibly, this is a reference to the joint-funding arrangement and to the threats that defendants communicated to plaintiffs. The Court did not state expressly, however, whether these additional acts formed a necessary part of the antitrust offense or wbether the repeated, indiscriminate opposition by itself was actionable. In his opinion concurring in the result Justice Stewart, joined by Justice Brennan, rejected the Court's analogy between such clearly illegal acts as bribery and fraud on the one hand and a pattern of baseless claims on the other. Because the first amendment protects even unfounded invocations of the adjudicatory process, the concurring justices argued, the defendants ran afoul of the antitrust laws not because of the manner in which they invoked the adjudicatory process but rather because, taken as a whole, their conduct evidenced the absence of a "genuine intent" to infiuence governmental action and thus fell within the *Noerr* sham exception. *Id.* at 517-18 (Stewart, J., concurring).

27. 410 U.S. 366 (1973).

28. The trial court explained that a " 'no-litigation certificate,' reflecting the absence of litigation which might impair the salability of revenue bonds, is essential to a successful sale of municipal bonds." United States v. Otter Tail Power Co., 331 F. Supp. 54, 62 (D. Minn. 1971).

the institution of litigation from antitrust penalties.[29] The Supreme Court, in light of its intervening decision in *Trucking Unlimited*, remanded the case to the trial court for a consideration of the *Noerr* immunity, as extended in *Trucking Unlimited* to the adjudicatory setting and, correspondingly, for an examination of the "mere sham" exception. The Court noted that in *Trucking Unlimited* it had held that the principle of the *Noerr* sham exception "may also apply to the use of administrative . . . processes where the purpose to suppress competition is evidenced by repetitive lawsuits carrying the hallmark of insubstantial claims . . . ."[30] The instant decision represents a recent attempt to synthesize the holdings of *Trucking Unlimited* and *Otter Tail* and to apply the "sham exception" in the context of an alleged abuse of the adjudicatory process.

## III. THE INSTANT OPINION

For the purpose of assessing the propriety of the district court's dismissal of plaintiffs' action, the instant court accepted plaintiffs' characterization of the municipal board as an adjudicatory body and of defendants' opposition before the board as "baseless."[31] Examining the specific language of the complaint, the court found no allegations of conduct amounting to a literal denial of "free and unlimited access" to the board.[32] The revocation of plaintiffs' permits suggested to the court no more than that plaintiffs and defendants had confronted one another before the board and that plain-

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29. *Id.*

30. 410 U.S. at 380. On remand the trial judge made the following brief finding:

> [T]he repetitive use of litigation by Otter Tail was timed and designed principally to prevent the establishment of municipal electric systems and thereby to preserve defendant's monopoly . . . . [T]he litigation comes within the sham exception to the Noerr doctrine as defined by the Supreme Court in [*Trucking Unlimited*] . . . .

United States v. Otter Tail Power Co., 360 F. Supp. 451-52 (D. Minn. 1973), *aff'd mem.*, 417 U.S. 901 (1974). For a general discussion of the *Noerr-Pennington* doctrine see Note, *The Quagmire Thickens: A Post-California Motor View of the Antitrust and Constitutional Ramifications of Petitioning the Government*, 42 U. CIN. L. REV. 281 (1973).

31. Referring to § 3.651 of the San Francisco City Charter, *see* note 4 *supra*, the court questioned whether the Board properly could be deemed an adjudicatory body in light of the "extremely broad standards governing the exercise of that body's discretion." 542 F.2d at 1079. Since the court felt that the board was actually a "political . . . body," it further questioned whether any opposition instituted before such a hody could be called "baseless."

> The relatively precise legal standards in light of which certain arguments may be characterized as "frivolous" are simply absent from the rough and tumble of the political arena; almost any position, including the self-interested plea of one competitor that another should be denied a permit, may be urged before such a political body.

*Id.*

32. "Nowhere in the complaint does McDonald's tell us, specifically, how or why or even whether the defendants' alleged efforts to infiuence the Board have in any way impaired McDonald's ability fully to present its views to the Board." *Id.*

tiffs had lost.[33] Defendants' own rights to appear before the board, even for anticompetitive purposes, the court noted, were protected by the immunity established in *Noerr* and extended to the adjudicatory process by *Trucking Unlimited*. The "sham exception" to that immunity, as articulated in *Noerr*,[34] was held inapposite because by its express terms the *Noerr* exception applied only to publicity campaigns, and because even if the *Noerr* exception did apply to direct petitioning efforts the exception could be invoked only in the absence of a genuine effort to influence a governmental body. In the instant case, the court asserted there was no doubt that defendants sought and obtained official action.[35] The court then decided that the "sham exception" in *Trucking Unlimited* was equally inapplicable. Although McDonald's complaint echoed the "access-barring" language of *Trucking Unlimited*, the instant court held that the denial of access in that case was achieved by threats of massive, jointly funded opposition that was intended to discourage the plaintiffs in *Trucking Unlimited* from invoking the adjudicatory process in the first place. The instant court found that the conduct alleged in McDonald's complaint had no such deterrent effect.[36] The court acknowledged the general proposition of *Trucking Unlimited* that the right to petition an administrative agency or court, although protected by the first amendment, does not confer absolute antitrust immunity on the petitioner regardless of the manner in which he invokes the process.[37] In light of the specific facts of *Trucking Unlimited*, however, the instant court reasoned that "this qualification means no more than that defendants who engage in *Noerr*-protected lobbying [or petitioning] activities may nevertheless subject themselves to antitrust liability if they engaged in activities

33. *Id.*

34. *See* text accompanying note 16 *supra*.

35. 542 F.2d at 1081. The court commented in a footnote that McDonald's might have a remedy in state court if the Board acted improperly, but the court knew of "no case that holds that joint action which succeeds in persuading a public body to make an erroneous decision can give rise to a cause of action under the Sherman Act." *Id.* at 1079 n.2.

36. The court elaborated:

> There is no allegation that defendants have conducted a publicity campaign, no allegation that their efforts are jointly financed, and, most importantly, no allegation that defendants have by communicating threats sought to deter McDonald's from filing permit applications. The only facts relied on to support the otherwise wholly conclusory access-barring allegation are the appearances of defendants' members . . . before the Board and the threats to withdraw political support, on three occasions. Both of these activities are clearly within the direct lobbying immunity recognized by *Noerr*, *Pennington* and *Trucking Unlimited* itself.

*Id.* at 1081.

37. *See* notes 25 & 26 *supra* and accompanying text.

external to or abusive of the . . . administrative or judicial process, which activities, like the threats of opposition in *Trucking Unlimited*, tend to 'harass and deter . . . competitors from having "free and unlimited access" to [appropriate] agencies.' "[38] Since in the court's view McDonald's had alleged only that their access to the municipal board had been limited by defendant's bad faith (but *Noerr*-protected) efforts to influence the board and had alleged no specific acts external to or abusive of the adjudicatory process, the court held that McDonald's complaint failed to state a cause of action under section 1 of the Sherman Act.[39]

The dissenting opinion charged the majority with having misread *Trucking Unlimited* and *Otter Tail*. According to the dissent, the gravamen of *Trucking Unlimited* was that a pattern of baseless, repetitive claims may in and of itself constitute a Sherman Act offense[40] when such a pattern evidences an intent to inflict competitive injury by barring competitors from "meaningful access" to adjudicatory proceedings. Under the dissenting opinion's reading of *Trucking Unlimited*, conduct in addition to the groundless invocation of the adjudicatory process, such as threats, need not be al-

38. 542 F.2d at 1081-82 n.4. Similarly in *Otter Tail*, the court argued, it was the use of threats of dilatory litigation that caused the loss of *Noerr* immunity, not the bare fact that the defendant there brought a series of spurious lawsuits. Furthermore, the court noted, Otter Tail Power Co. could achieve its anticompetitive purpose of retarding the sale of municipal bonds simply by filing lawsuits, without regard to the final outcome of the litigation. By contrast, the instant defendants could block only McDonald's efforts to build new restaurants by successful invocation of the permit review process. This fact supported the court's earlier conclusion that the defendants were engaged in a genuine effort to influence governmental action.

39. The court conceded that under ordinary notice pleading rules, McDonald's complaint would survive a motion to dismiss, and plaintiffs would be allowed to use discovery to develop proof of the types of specific conduct the court felt were necessary to establish a denial of "free and unlimited access" to the adjudicatory process. The court argued, however, that holding plaintiffs' "conclusory access-barring incantation" sufficient to state a Sherman Act cause of action might chill the exercise of first amendment rights. Although the court disclaimed any intent to require "fact pleading" in antitrust cases, the court held

> that in any case, whether antitrust or something else, where a plaintiff seeks damages or injunctive relief, or both, for conduct which is prima facie protected by the First Amendment, the danger that the mere pendency of the action will chill the exercise of First Amendment rights requires more specific allegations than would otherwise be required.

542 F.2d at 1082-83. A full discussion and analysis of the rationale underlying this procedural aspect of the instant opinion is beyond the scope of this comment. It is sufficient for present purposes to note the court's marked solicitude for first amendment values.

40. If there were any doubt as to the majority's meaning in *Trucking Unlimited*, it would be dispelled by the opinion of Justice Stewart [*see* note 26 *supra*] who . . . declined to join the majority opinion specifically because the majority held that Sherman Act liability may be based upon the manner in which defendants exercise their First Amendment right of access to an adjudicatory tribunal.

542 F.2d at 1087.

leged. In support of this conclusion the dissent cited the *Otter Tail* language that summarized the "sham exception" solely in terms of baseless, repeated claims and that made no mention of threats or other conduct.[41]

## IV. COMMENT

The instant decision is based on a very narrow reading of *Trucking Unlimited* and *Otter Tail* and severely limits, at least in the Ninth Circuit, the development of the *Noerr* "sham exception" in the context of the adjudicatory process. The court perhaps was correct in its observation that both *Trucking Unlimited* and *Otter Tail* dealt with factual situations significantly different from that in the instant case and that the holdings in those cases, viewed in the light of their unique facts, did not provide direct authority for allowing McDonald's complaint to stand. By contrast, however, as the dissenting opinion noted, the language of *Trucking Unlimited* and *Otter Tail*, when divorced from the specific facts in those cases and read as general statements of law, is broad enough to cover the conduct alleged in McDonald's pleadings.[42] Several factors, as discussed below, suggest that the instant court's avoidance of the more expansive language of the *Trucking Unlimited* and *Otter Tail* holdings as a means of circumscribing the *Noerr* "sham exception" was unjustified.

In discussing the *Noerr* "sham exception," *Trucking Unlimited* emphasized that "misconduct" in the context of administrative or judicial proceedings cannot enjoy antitrust immunity under the guise of "political expression" protected by the first amendment.[43] If, as the instant court suggested, the essence of the Sherman Act offense in *Trucking Unlimited* was conduct external to the adjudicatory process[44]—the defendants' open threats of continual opposition and the joint-funding arrangement—the *Trucking Unlimited* court would not have had to carve out a "sham exception." By definition, conduct external to the adjudicatory process does not enjoy *Noerr* immunity. Furthermore, it seems unlikely that the Court would have refused to impose antitrust liability if the *Trucking Unlimited* defendants had refrained from communicating any threats of their

41. *See* text accompanying note 30 *supra*. The dissenting opinion noted that on remand the district court's finding mentioned only defendant's repetitive use of litigation.

42. Compare, for example, the broad statement in *Otter Tail*, *see* text accompanying note 30 *supra*, cited by the dissenting opinion, with the instant majority's reading of *Trucking Unlimited*, which integrated both facts and holding, *see* text accompanying note 38 *supra*.

43. *See* text accompanying note 25 *supra*.

44. *See* notes 37 & 38 *supra* and accompanying text.

intended opposition, confident instead that plaintiffs would soon discover the scheme by empirical observation, or if defendants had financed their opposition on an individual basis rather than via a joint-funding arrangement. More plausible is the conclusion that the "misconduct" that caused the defendants in *Trucking Unlimited* to lose *Noerr* immunity was the pattern of indiscriminate, repetitious claims that in and of itself was sufficient to deter and harass the plaintiffs from having meaningful access to the adjudicatory process. The threats and the joint funding were significant only because they lent additional credibility to the plaintiffs' claims that the pattern of opposition was indiscriminate and conducted for anticompetitive purposes.[45] The instant plaintiffs have in a sense stated a stronger case: whereas the plaintiffs in *Trucking Unlimited* alleged opposition with or without probable cause,[46] McDonald's alleged that the instant defendants' opposition was entirely unfounded and conducted solely to frustrate plaintiffs as competitors.[47]

Although the preceding analysis represents only one possible interpretation of the significance of *Trucking Unlimited* and *Otter Tail*, sound policy reasons support construction in McDonald's favor of any ambiguities in those Supreme Court decisions. The instant court's reluctance to uphold McDonald's complaint is due in part to the conviction, derived from *Noerr*, that the Sherman Act was intended to regnlate "business activity" and not "political activity."[48] Not only does *Trucking Unlimited* reject the notion that "misconduct" in the adjudicatory setting properly can be characterized as *Noerr*-protected "political activity,"[49] but also the current pervasiveness of governmental regulation of business makes questionable the continued vitality of *Noerr*'s neat distinction between government and business. The instant court's condonation of baseless opposition before a regulatory body creates a significant and unnecessary loophole in the antitrust laws. The court's suggestion that McDonald's may have a remedy in state court if the board improperly denied their permits does not explain adequately why they cannot also maintain an antitrust action against defendants for

45. The immateriality of the presence of threats to the holding of *Trucking Unlimited* is supported by the absence of mention in any of the *Otter Tail* opinions of conduct other than the simple filing of lawsuits.

46. *See* note 19 *supra*.

47. The fact that the Board was swayed by defendants' arguments should create no more than a rebuttable presumption that the opposition was meritorious.

48. *See* note 15 *supra* and accompanying text.

49. *See* text accompanying note 25 *supra*.

inducing those erroneous decisions. Certainly the antitrust laws were not designed to permit review of every administrative or judicial ruling that has an anticompetitive effect on the losing party. Nevertheless, the Sherman Act ought to be broad enough to impose sanctions on groups of business interests who pool their resources and ingenuity for the purpose of playing repeatedly upon the fallibility of adjudicatory tribunals in order to induce decisions that have severe anticompetitive impact and that can be shown in a separate antitrust action to be wholly without merit.

Finally, the instant court argued that allowing the joint sponsorship of a pattern of baseless litigation to constitute an antitrust violation would have a chilling effect on the valid exercise of the first amendment right to petition.[50] This hypothesis is difficult to refute. It is submitted, however, that in the adjudicatory setting standards for determining whether opposition is "frivolous" are fashioned much more easily than are criteria for measuring the validity of proposals urged before legislative bodies.[51] Furthermore, a rigid standard of proof for establishing the baselessness of a competitor's repeated opposition would ensure that potential plaintiffs use considerable discretion in bringing a cause of action under section 1 of the Sherman Act.

SAMUEL E. STUMPF, JR.

# Constitutional Law—First Amendment—Student's Right to Receive Information Precludes Board's Removal of Allegedly Offensive Books from High School Library

## I. FACTS AND HOLDING

Plaintiff high school students[1] brought a class action[2] seeking

50. *See* note 39 *supra*.

51. The instant court itself recognized the greater precision with which "baseless" arguments could he identified in the adjudicatory setting. *See* note 31 *supra*.

1. Plaintiffs were enrolled in schools of the Strongsville City School System.

2. Subject matter jurisdiction was based on 28 U.S.C. § 1343 (1970), which provides:

> The district courts shall have original jurisdiction of any civil action authorized by law to be commenced by any person:
>
> (3) To redress the deprivation, under color of any State law, statute, ordinance, regulation, custom or usage, of any right, privilege or immunity secured

declaratory and injunctive relief to compel defendant school officials[3] to return books[4] removed from the school library[5] because defendants found the content of the books objectionable.[6] Plaintiffs claimed that removal of the books solely because their content offended defendants' personal tastes violated 42 U.S.C. § 1983[7] and the first and fourteenth amendments.[8] On motion to dismiss, defendants contended that plaintiffs' first amendment rights did not restrict the school board's power to censor the school library and to remove books with subject matter distasteful to board members.[9] The district court dismissed the complaint.[10] On appeal, the United States Court of Appeals for the Sixth Circuit *held,* reversed. Because the first amendment guarantees a student's right to receive information, it precludes removal of books from a public school library on the sole ground that school officials find the content of

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by the Constitution of the United States or by any Act of Congress providing for equal rights of citizens . . . .

3. Defendants were the Strongsville City School District, the members of the Board of Education, and the Superintendent of the school district.

4. At a special meeting of the Strongsville School Board on August 19, 1972, the following motion was made and carried:

Dr. Cain moved, seconded by Mr. Henzey, that the textbook entitled *Cat's Cradle* not be used any longer as a text or in the library in the Strongsville schools.

Similarly, at a meeting of the Board on August 31, 1972, the following action was recorded in the minutes:

Mrs. Wong moved, seconded by Dr. Cain, that the textbook *Catch 22* be removed from the library in the Strongsville schools.

5. The Board's order regarding removal of the books was made pursuant to the authority granted by 33 OHIO REV. CODE ANN. § 3329.07 (Page 1972), which provides:

The board of education of each city, exempted village, and local school district shall cause it to be ascertained and at a regular meeting determine which, and the number of each of the textbooks the schools under its charge require.

6. The complaint also alleged that the Board's action in refusing to approve Joseph Heller's *Catch 22* and Kurt Vonnegut's *God Bless You, Mr. Rosewater* as texts or library hooks and its resolution prohibiting teacher and student discussion of the books denied plaintiffs their right to learn freely and thereby constituted a prior restraint on freedom of speech secured by the first and fourteenth amendments.

7. 42 U.S.C. § 1983 (1970) provides:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or any other persons within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

8. The first amendment provides that Congress shall make no law abridging freedom of speech. U.S. CONST. amend. I. The fourteenth amendment makes this proscription applicable to the states. U.S. CONST. amend. XIV.

9. A motion to intervene as defendants was made on behalf of other students in the high school by their parents, indicating that plaintiffs' requested relief was not compatible with the wishes and interests of all high school students in the Strongsville System.

10. 384 F. Supp. 698 (N.D. Ohio 1974).

the books objectionable. *Minarcini v. Strongsville City School District,* 541 F.2d 577 (6th Cir. 1976).

## II. Legal Background

Throughout the history of federal court adjudication of first amendment cases, jurists have recognized that the reciprocal character of communication provides the basis for a right to hear as well as a right to speak.[11] It was not until the 1960's, however, that the federal courts focused on the juxtaposition between freedom of expression and the interest in receiving information, either directly from a source whose speech is constitutionally protected, or indirectly through books and other publications.[12] *Lamont v. Postmaster General,*[13] the first significant case bearing upon the nature of a constitutional right to receive information, examined the validity of a federal statute[14] requiring addressees to fill out a form reply card before receiving printed material from Communist countries. Plaintiffs[15] asserted a constitutional right to receive such mail unimpeded by the disclosure of their identity assured by the reply cards. A unanimous Supreme Court[16] invalidated the statute "because it require[d] an official act . . . as a limitation on the unfettered exercise of the addressee's First Amendment rights."[17] The opinion said little about the nature of the underlying constitutional interest.[18] A concurring opinion by Justice Brennan, however, did

11. *E.g.,* Martin v. City of Struthers, 319 U.S. 141, 143 (1943). For an early discussion bearing on the constitutional right to receive information and ideas, see Meiklejohn, *Freedom to Hear and to Judge,* 10 Law. Guild Rev. 26 (1950).

12. There is scant, though respectable, authority supporting the idea that the framers of the first amendment meant to protect botb ends of the communication process. James Madison, chairman of the committee that drafted the first amendment, said of the relationship between information and responsible citizenship:

> Knowledge will forever govern ignorance; and a people wbo mean to be their own Governors, must arm themselves with the power which knowledge gives. A popular government without popular information *or the means of acquiring it,* is but a prologue to a farce or tragedy, or, perhaps both. Letter from James Madison to W.T. Barry (Aug. 4, 1822), in 9 Writings of James Madison 103 (G. Hunt ed. 1910) (emphasis supplied).

*See also* O'Neil, *Libraries, Liberties and the First Amendment,* 42 U. Cin. L. Rev. 209, 220-22 (1973).

13. 381 U.S. 301 (1965).

14. Act of Oct. 11, 1962, Pub. L. No. 87-793, § 305(a), 76 Stat. 840.

15. Failure of the addressee to return a signed card for each piece of "communist political propaganda" would result in the eventual destruction of the material. Plaintiffs were addressees wishing to receive communist publications through the United States mails.

16. Justice Douglas authored the opinion of the Court.

17. 381 U.S. at 305.

18. Some commentators give a broad reading to *Lamont,* despite the cryptic quality of the opinion: "The case is also interesting, it should be noted, as protecting the right to receive, as distinct from sending, communications." T. Emerson, The System of Freedom of

develop more fully the relevant constitutional claim:

> [T]he protection of the Bill of Rights goes beyond the specific guarantees to protect from congressional abridgement those equally fundamental personal rights necessary to make the express guarantees fully meaningful . . . . I think the right to receive publications is such a fundamental right. The dissemination of ideas can accomplish nothing if otherwise willing addressees are not free to receive and consider them.[19]

Subsequent cases involving bans on speakers at state college and university campuses[20] focused more directly on the substantial infringement on the interests of both speaker and listener imposed by governmental censorship. *Snyder v. Board of Trustees*[21] is typical of lower federal court reaction to student claims predicated on a first amendment interest in the receipt of information and ideas. In *Snyder* a federal district court declared unconstitutional an Illinois statute denying access to university facilities to "any subversive, seditious, and un-American organization"[22] in response to student claims that the challenged law denied them access to speakers they wished to hear in violation of the first amendment.[23] Relying on Justice Brennan's opinion in *Lamont*,[24] the Court held that "a First Amendment right to peacefully assemble to listen to the speaker of one's choice . . . may not be impaired by state legislation any more than the right of the speaker may be impaired."[25]

The trend in the lower federal courts to afford first amendment

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EXPRESSION 593-626 (1970). For a narrower reading, see O'Neil, *supra* note 12, at 219, where Professor O'Neil concludes that the Court never really held that the addressee has a constitutional right to receive particular material through the mails: "It held only that Congress could not require the addressee, as a condition of receiving such material, to disclose on a separate post card his desire to receive each piece of suspect mail. . . . It was the *condition* . . . and not the *restriction*, that was unconstitutional." Such a construction of *Lamont* would assimilate it into the body of law dealing with unconstitutional conditions on government benefits. The notion behind the doctrine of unconstitutional conditions is that government power to deny a benefit outright does not necessarily imply a power to condition access to that benefit upon the surrender of other liberties. *See generally* O'Neil, *Unconstitutional Conditions: Welfare Benefits With Strings Attached*, 54 CALIF. L. REV. 443, 474 (1966); Note, *Unconstitutional Conditions*, 73 HARV. L. REV. 1595 (1960).

19. 381 U.S. at 308.

20. *E.g.*, Brooks v. Auburn University, 412 F.2d 1171 (5th Cir. 1969); Smith v. University of Tennessee, 300 F. Supp. 777 (E.D. Tenn. 1969). *See generally* Pollitt, *Campus Censorship: Statute Barring Speakers from State Educational Institutions*, 42 N.C.L. REV. 179 (1963); Van Alstyne, *Political Speakers at State Universities: Some Constitutional Considerations*, 111 U. PA. L. REV. 328 (1963).

21. 286 F. Supp. 927 (N.D. Ill. 1968).

22. ILL. REV. STAT. ch. 144, § 48.8 (1964).

23. The dispute resulted from the refusal of university officials to allow Louis Deskin, a member of the Communist Party of the United States, to speak on such topics as "Communism and Youth" and "The Communist Party Platform" at campus meetings.

24. *See* note 19 *supra* and accompanying text.

25. 286 F. Supp. at 932.

protection for a right to receive information gained impetus in the 1972 Supreme Court decision in *Kleindienst v. Mandel.*[26] In *Mandel* a Marxist writer[27] challenged the denial of his entry into the United States under the Immigration and Nationality Act, which barred from entry persons who publish or advocate "the economic, international, and governmental doctrines of World communism."[28] Plaintiff claimed that his exclusion violated both his own personal right of entry and the first amendment rights of American scholars to whom he had been invited to speak.[29] While the majority found plaintiff's claims overridden by the federal government's plenary power of exclusion,[30] they acknowledged that first amendment issues were presented by the scholars' invitation to Mandel. Despite the disposition of the case, the Court did strengthen the constitutional underpinnings of a right to receive information. Justice Blackmun noted that the Court had referred to a first amendment right to "receive information and ideas" in a variety of contexts.[31] The Court stated specifically that the right was particularly significant in the academic community.[32]

Any doubt regarding the status of the right to receive information[33] was resolved by the recent Supreme Court decision in *Virginia State Board of Pharmacy v. Virginia Citizens Consumers Council, Inc.*[34] Users of prescription drugs[35] contended that a Virginia statute[36] prohibiting pharmacists from advertising drug prices violated

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26. 408 U.S. 753 (1972).

27. Ernest Mandel was a Belgian Marxist writer and theorist.

28. 8 U.S.C. §§ 1182(a)(28)(D), (G)(v), (d)(3)(A) (1970).

29. The lower court ruled that Mandel, as an alien, had no personal right of entry that Congress could not restrict or abolish. It went on, however, to bold that citizens of the United States did have a first amendment right to hear Mandel speak, and on that basis enjoined enforcement of the statute. Mandel v. Mitchell, 325 F. Supp. 620 (E.D.N.Y. 1971).

30. 408 U.S. at 765-66.

31. *Id.* at 762.

32. The Court cited loyalty oatb cases and other decisions involving academic freedom. *See, e.g.*, Keyishian v. Board of Regents, 385 U.S. 589, 603 (1967); Shelton v. Tucker, 364 U.S. 479, 487 (1960); Sweezy v. New Hampshire, 354 U.S. 234, 250 (1957).

33. Prior to Virginia State Board of Pharmacy v. Virginia Citizens Consumers Council, Inc., 425 U.S. 748 (1976), it was arguable that the first amendment protected only the speaker or writer because the framers did not specifically safeguard the interests of listeners or readers. Proponents of this argument claimed that the very force of the Bill of Rights as a guarantor of free expression obviated the need to safeguard freedom of reception. O'Neil, *supra* note 12, at 217.

34. 425 U.S. 748 (1976).

35. Plaintiffs were Virginia residents who were required to take prescription drugs on a daily basis, and two non-profit organizations, the Virginia Citizens Consumers Council, Inc., and the Virginia State AFL-CIO, each baving substantial membership of prescription drug users.

36. VA. CODE § 54-524.35 (Supp. 1974) provides:

plaintiffs' first amendment right to receive information that pharmacists wished to communicate to them through advertising. Relying primarily on *Mandel,* the Court noted that "where a speaker exists, as is the case here, the protection afforded is to the communication, to its source and to its recipients both"[37] and held that "[i]f there is a right to advertise, there is a reciprocal right to receive the advertising."[38]

Since, as the language in *Virginia State Board of Pharmacy* suggests, the scope of the right to receive information is coextensive with the right to communicate,[39] the protection afforded the right to receive information in a particular context must be examined in light of first amendment guarantees extended to freedom of expression. In the educational context, therefore, teacher assertions of a first amendment right to teach are relevant in determining the scope of the first amendment right to receive information in the public school classroom.[40] Determinations of the extent of such

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Any pharmacist shall be guilty of unprofessional conduct who . . .

(3) publishes, advertises or promotes, directly or indirectly, in any manner whatsoever, any amount, price, fee, premium, discount, rebate, or credit terms for professional services or for drugs containing narcotics or for any drugs which may be dispensed only by a prescription.

37. 425 U.S. at 756. In dictum, the Court mentioned other contexts in which a right to receive information had been acknowledged. *See, e.g.*, Procunier v. Martinez, 416 U.S. 396 (1974) (suggesting right of addressee to receive uncensored mail from prisoners); Red Lion Broadcasting Co. v. FCC, 395 U.S. 367 (1969) (the interest of the listener in receiving fair and balanced material through the broadcast media); Stanley v. Georgia, 394 U.S. 557 (1969) (right to possess and read in private material that might be legally obscene).

38. 425 U.S. at 757.

39. *Id.*

40. The classroom setting, particularly at the secondary and primary levels, is unique. Traditional educational precepts define the function of lower-level education as the inculcation of certain ideas, skills, knowledge, and information essential to society. This "cultural transmission," or "prescriptive," approach refuses to apply the marketplace of ideas model, on which the first amendment is grounded, to the public school classroom. *See* Goldstein, *The Asserted Constitutional Right of Public School Teachers to Determine What They Teach,* 124 U. PA. L. REV. 1293, 1350-55 (1976). In recent years, however, the value inculcation model has drawn fire from certain factions within the academic community. An increasing number of educators have come to condemn the role of public schools as conduits for indoctrination of community values. These "progressives" see as the function of education the stimulation of intellectual creativity through a robust exchange of ideas. The classroom thus becomes an intellectual "marketplace" where the first amendment imposes at least minimal restrictions on government control. The marketplace model as yet has found little favor in the courts. The outcome of any particular case involving the application of first amendment rights is still in large part dependent upon which educational philosophy most appeals to a majority of the court. *See* Note, *Academic Freedom in the Public Schools: The Right to Teach,* 48 N.Y.U.L. REV. 1176, 1180-82 (1973). *See also* Tinker v. Des Moines Indep. School Dist., 393 U.S. 503 (1969). In *Tinker,* a majority of the Court seemed to adopt the progressive view of education in proscribing school efforts to censor extracurricular student speech (the wearing of black armbands to protest the Vietnam War). The Supreme Court, however, has not been asked to apply the same philosophy in a case involving classroom expression that affects school curriculum.

rights necessarily entail analysis of a teacher's authority to determine methods of instruction contrary to the wishes of school authorities.[41] In *Keefe v. Geanakos,*[42] the First Circuit considered a high school teacher's suit to enjoin his discharge for discussing a "vulgar" word[43] that appeared frequently in an article assigned for class discussion. Although acknowledging that some public regulation of conduct inheres in every provision of lower level public education, the court granted a preliminary injunction concluding that plaintiff would probably prevail on the merits.[44] Since plaintiff's use of the word served a demonstrated educational function,[45] his right to teach outweighed the state's interest in exercising absolute control over classroom teaching methods.[46]

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41. The modern doctrine of academic freedom usually refers to the concept that a university faculty member is free to teach and a college student is free to learn whatever he or she thinks best under the first amendment with only the most minimal restraints by university authorities or government agencies. At the elementary and secondary levels, however, there is no strong tradition of intellectual freedom as in the college and university setting. As a consequence, many educators conclude that the judicial doctrine of academic freedom is not applicable to the public high school teacher or student. In support of this notion is the argument that students in public schools are at an impressionable age where exposure to controversial ideas would be detrimental. *See* note 40 *supra.* Professor Goldstein argues that neither sound constitutional analysis nor authoritative precedent supports a federal constitutional right of teachers to determine what they teach contrary to the desires of school authorities. According to Goldstein, the freedom of expression rationale is inapplicable to the high school setting since it is premised on an analytical model that views the classroom as a marketplace of ideas. Goldstein, *supra* note 40, at 1351-55. Professor Nahmod, on the other hand, proposes that the Constitution requires the adoption of the marketplace of ideas model in public education:

> It is true that *Lamont* and the cases on controversial campus speakers involve adults or college students who are generally more mature than high school students. Moreover, a high school classroom would seem to be a more controlled and restricted marketplace of ideas than the mail or college campuses, if only because of compulsory attendance and, frequently, a uniformly required curriculum. Nevertheless, . . . it is clear that students cannot be insulated from controversial subjects in school. If this applies to student expression through worn symbols [and] underground newspapers, . . . then it would seem both inconsistent and educationally unworkable to prohibit student access to controversial subjects through supervised classroom presentations.

Nahmod, *Controversy in the Classroom: The High School Teacher and Freedom of Expression,* 39 GEO. WASH. L. REV. 1032, 1055 (1971).

42. 418 F.2d 359 (1st Cir. 1969).

43. Plaintiff gave each member of his senior English class a copy of the September, 1969, *Atlantic Monthly* magazine, and assigned the first article therein. In the course of discussion plaintiff explained the origin of the word "motherfucker," its context, and the reasons the author had included it. The teacher defended his discussion of the word as important to the development of the thesis and conclusions of the article.

44. The court also expressed concern for the chilling effect that might result from "such rigorous censorship." 418 F.2d at 362.

45. In determining whether discussion of the article served an educational function, the court read the article and made its own judgment as to its appropriateness in a high school classroom, without benefit of any expert testimony.

46. The court held alternatively that plaintiff probably had not received constitution-

The protection afforded a right to teach was expanded in *Parducci v. Rutland,*[47] an action to enjoin a high school teacher's discharge for assigning allegedly offensive reading material to her English class.[48] Upholding plaintiff's contention that her dismissal violated her first amendment "right to academic freedom," the court noted that teachers' entitlement "to First Amendment freedoms is an issue no longer in dispute."[49] The court observed that, although academic freedom is not an enumerated first amendment right, a fundamental right to teach inheres in the view of the classroom as a marketplace of ideas.[50]

Other courts have been less willing to recognize a first amendment right to teach sufficient to outweigh a governmental interest in regulating the content of classroom discussion. For example, in *Mailloux v. Kiley,*[51] a high school teacher challenged his dismissal for writing the word "fuck" on the blackboard to illustrate the concept of taboo words.[52] Initially, the district court, regarding itself as bound by the First Circuit's opinion in *Keefe,* granted a preliminary injunction.[53] On the merits, however, the court concluded that Mailloux's use of a teaching method that was not approved by the weight of opinion[54] in the teaching profession and that was merely relevant

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ally adequate notice that his conduct was forbidden. 418 F.2d at 362.

47. 316 F. Supp. 352 (M.D. Ala. 1970).

48. The teacher assigned Kurt Vonnegut, Jr.'s *Welcome to the Monkey House,* which school authorities described as "literary garhage."

49. 316 F. Supp. at 354.

50. The court referred to Tinker v. Des Moines Indep. Community School Dist., 393 U.S. 503, 512 (1969), in which the Supreme Court stated:

> The vigilant protection of constitutional freedoms is nowhere more vital than in the community of American schools. The classroom is pecularily the "marketplace of ideas."

*But see* Goldstein, *supra* note 40, at 1351-55, in which he notes that *Tinker* did not involve student expression in the classroom context. According to Goldstein, the language in *Tinker* describing the high school classroom as a marketplace of ideas is gratuitous.

51. 436 F.2d 565 (1st Cir.), *after dismissal,* 323 F. Supp. 1387 (D. Mass.), *aff'd per curiam,* 448 F.2d 1242 (1st Cir. 1971).

52. The teacher had led a class discussion of *A Thread that Runs so True,* a novel that described the difficulties encountered by a schoolteacher who attempted to intermingle the previously segregated seating of boys and girls. During the discussion, a numher of students expressed opinions that parental protests against seating were ridiculous. Mailloux stated that modern prejudices were just as ridiculous and attempted to illustrate his point by the discussion of tahoo words. Neither the subject of taboo words nor the word "fuck" appeared in the novel being discussed.

53. 323 F. Supp. at 1389.

54. The court concluded that on the basis of the expert testimony it could not state that the weight of opinion in the teaching profession as a whole or the weight of opinion among English teachers would support Mailloux's conduct. Nor could the court determine on its own that the teaching plainly served a demonstrated educational purpose. *Id.* at 1390. Nevertheless, the court invalidated the school board's action on the ground that Mailloux had not been afforded adequate procedural protection. The court's arguments for refusing to extend the

to his subject[55] did not come within its interpretation of the substantive right to academic freedom upheld in *Keefe* and *Parducci*. Nor would the court extend the right to teach to methods designed merely to expose students to a variety of ideas, but restricted the right to those cases in which the educational purpose clearly had been demonstrated.

Similarly, the United States Court of Appeals for the Second Circuit has refused to recognize the broad right to teach articulated in *Parducci* and *Keefe*. In *President's Council v. Community School Board*,[56] plaintiff parents, teachers, librarian, and students challenged a New York City Community School Board's removal of copies of *Down These Mean Streets*[57] from all junior high school libraries in the district.[58] Unlike the *Keefe, Parducci,* and *Mailloux* courts, the Second Circuit upheld the action of the school board without discussing the value or harm of the book. Dismissing *Keefe* and *Parducci* as not controlling since both involved dismissals with concomitant issues of procedural due process not present here,[59] the court noted that "[t]o the extent these cases hold that first amendment rights have been violated whenever a district court disagrees with the judgment of school officials as to the propriety of material assigned by a teacher,"[60] they are erroneous. The court refused to

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substantive right of *Keefe* and *Parducci* are as follows:

> While secondary schools are not rigid disciplinary institutions, neither are they open forums in which mature adults, already habituated to social restraints, exchange ideas on a level of parity. Moreover, it cannot be accepted as a premise that the student is voluntarily in the classroom and willing to be exposed to a teaching method which, though reasonable, is not approved by school authorities or by the weight of professional opinion.

*Id.* at 1392. These arguments indicate that the court was not willing to accept the progressive philosophy employed by the *Keefe* and *Parducci* courts. *See* notes 40 & 41 *supra*.

55. In regard to Mailloux's conduct, the court stated that it was an undecided question whether a teacher has a substantive constitutional right to use a teaching method that was merely "relevant to his subject and his students and, in the opinion of experts of significant standing, serves a serious educational purpose . . ." 323 F. Supp. at 1391.

56. 457 F.2d 289 (2d Cir.), *cert. denied*, 409 U.S. 998 (1972).

57. The book in question is an autobiographical account by Piri Thomas of a Puerto Rican youth growing up in New York City's Spanish Harlem. The book is replete with taboo phrases and expressions; its dialogue seeks to capture the realities of life in Spanish Harlem through the eyes and ears of a resident. Some parents objected to the library's stocking the book, which they claimed would have an adverse moral and psychological effect on their children. As a response to these complaints, the board ordered the books removed from the lihrary.

58. Classroom discussion of the problems of Spanish Harlem was not prohibited by the board's order.

59. 457 F.2d at 294.

60. *Id.* at 293-94.

consider contentions that, in effect, the board was attempting to censor classroom discussion by eliminating the book as an adjunct to that discussion. Instead, the court defined the issue as requiring a determination of what authority properly should select books or curriculum and concluded that teachers had no constitutional right to be the selectors.[61] Thus prior to the instant case, no court had held that removal of books from a public school library implicated either a teacher's academic freedom to communicate or a student's reciprocal right to receive information.

## III. THE INSTANT OPINION

The instant court initially examined[62] the apparent Second Circuit pronouncement of school officials' absolute authority to remove books from the library free from constitutional restraints. Emphasizing that the Second Circuit found such unbridled authority only when "no showing of a curtailment of freedom of speech or thought"[63] was present, the court held that the instant case did involve curtailment of first amendment interests since the school board's only purpose in excising the books was to limit student exposure to ideas the board found distasteful.[64] In considering whether defendants' conduct in these circumstances violated plaintiffs' first amendment rights the court acknowledged that neither

61. The court noted:

> The administration of any library, whether it be a university or particularly, a public junior high school, involves a constant process of selection and winnowing based not only on educational needs, but financial and architectural realities. To suggest that the shelving and unshelving of books presents a constitutional issue, particularly where there is no showing of a curtailment of freedom of speech or thought, is a proposition we cannot accept.

*Id.* at 293.

62. Before turning to the question whether removal of the books violated plaintiffs' first amendment rights, the court examined and rejected the claim that refusal to purchase certain books recommended by a teachers' committee infringed upon freedom of expression:

> Clearly, discretion as to the selection of textbooks must be lodged somewhere and we can find no federal constitutional prohibition which prevents its being lodged in school board officials who are elected representatives of the people. . . . In short, we find no federal constitutional violation in this Board's exercise of curriculum and textbook control as empowered by the Ohio statute.

541 F.2d at 579-80. The court also noted that there was no evidence in the record to show that teachers and students were proscribed from discussing the subjects contained in the books in the classroom. *Id.* at 584.

63. President's Council v. Community School Bd., 457 F.2d 289, 293 (2d Cir. 1972); *see* note 61 *supra.*

64. The court noted that while the need for shelf space or wearing out of books might require some selection of books to be disposed of, no such rationale was involved in this case. The board's purpose, as the court discerned, was to "winnow" the library for books the content of which occasioned their displeasure. 541 F.2d at 582.

state nor school officials are required constitutionally to provide a library for students and teachers.[65] Nevertheless, the court held that, once the state had created the benefit, it could not impose conditions on the exercise of the privilege without violating plaintiffs' first amendment interests. The board's action was analogized to unconstitutionnal government attempts to constrain the communication of undesirable ideas, not by imposing outright restrictions on the source or the recipients, but by imposing conditions on access to the information.[66] Thus, since eliminating the library as a source for the books in question hindered plaintiffs' endeavors to acquire the information contained therein[67] by imposing a serious burden on classroom discussion of their content and ideas, the court concluded that the first amendment protection afforded the students' "right to know" precluded removal of the books for reasons related solely to the political and social tastes of school board members.

## IV. COMMENT

The instant case creates a split of authority at the circuit court level by deciding that the first amendment prohibits state officials from purging a public school library of books whose content they find objectionable. The Second Circuit in *President's Council* was unnecessarily insensitive to plaintiffs' first amendment claims, regarding the issue as merely what authority, teacher or school board, has the responsibility of selecting books for a school library.[68] The court apparently based its decision on a different sort of case—a school board's refusal to buy or shelve a particular book—and thus did not deal directly with the case actually before it in which a book already purchased and placed on the shelf was being recalled. The distinction between the two cases, however, did not escape the instant court. Although the claim of curtailment of freedom of expression was not couched in familiar first amendment terms, the court quite properly recognized that removal of the books involved a state attempt to chill classroom discussion by making unavailable a valu-

65. Justice Edwards in a footnote added:

> On the other hand, it would be consistent with the First Amendment (although not required by it) for every library in America to contain enough books so that every citizen in the community could find at least some which he or she regarded as objectionable in either subject matter, expression or idea.

*Id.* at 582 n.1.

66. *See* note 18 *supra.*

67. The court referred to the library as "a mighty resource in the free marketplace of ideas," and noted that it "is specially dedicated to broad dissemination of ideas." 541 F.2d at 582-83.

68. *See* text accompanying notes 60 & 61 *supra.*

able tool through which a teacher might convey particular information and ideas. In holding that the board's order removing the books violated the first amendment by imposing a serious burden on the students' acquisition of information and ideas, the instant decision expands the constitutional protection afforded the right to receive information to the public high school classroom.[69]

Recognition of a first amendment right to receive information in the public high school classroom necessarily encompasses the concept of academic freedom adopted by the *Keefe* and *Parducci* courts.[70] By affording constitutional status to a student's right to know, the instant court acknowledges that the first amendment attaches to a teacher's classroom activity not merely for her own benefit, but also to create in the classroom an intellectual marketplace of ideas. The marketplace model adopted by the court is akin to that which exists in traditional public forums associated with the educational process—the auditorium, the amphitheatre, the school grounds—where the interest in allowing an interchange of diverse ideas compels adoption of first amendment guarantees. While application of the marketplace model to the high school classroom is less obvious, and even highly controversial,[71] the interest in establishing in the high school student[72] the raw materials with which to question and probe accepted values and ideas is comparable to those interests traditionally protected by the first amendment in educational forums like the university classroom. The instant decision illustrates how a court embracing the progressive philosophy of education may employ the first amendment to curtail state power to monopolize classroom discussion under the guise of its authority to make textbook selection.[73] To a court adopting the prescriptive view, any first amendment interest obviously is outweighed by the state's interest in transmitting basic values, skills, and knowledge

69. *See* note 37 *supra* for other contexts in which a right to receive information has heen recognized.

70. *See* notes 46, 49 & 50 *supra* and accompanying text.

71. *See* note 40 *supra.*

72. The high school classroom is perhaps more analogous to the university classroom than it is to the classroom at the junior high or, particularly, the elementary level. Since high school students arguably are less impressionable than children on the junior high level, the state's interest in protecting children from exposure to certain ideas and concepts should decrease in the context of higher level public education. This distinction may explain the reluctance of the Second Circuit to impose the concept of academic freedom on the New York City junior high school as contrasted with the willingness of the *Keefe, Parducci* and instant courts to apply it on the secondary level.

73. The court thus rebuts the notion that *Keefe* and *Parducci* stand *only* for the proposition that a teacher cannot be fired for using a teaching method disapproved by his other superiors without receiving appropriate notice and heing afforded an opportunity to be heard.

which, according to the Second Circuit, compels restraint of classroom speech when the subject matter is disapproved by school officials.

The court might have avoided the philosophical controversy inherent in a decision based on substantive first amendment rights by focusing on the school board's deviation from its customary administrative procedure for determining what books are maintained in the school library. This process of selection involves not only a choice as to additional books to be shelved, but also a determination of whether a worn-out book will be replaced or whether a book will be disposed of when shelf space becomes a problem. In either case the selection method employed by the Strongsville School Board and its ultimate decision are consistent with procedural due process. A board committee meets with faculty and citizens to discuss recommended books prior to the board's final selection decision.[74] While there is no doubt as to the propriety and legality of vesting in the school board this general power of selection when the selection method is consistent with procedural due process guarantees, each of the instances of removal in the present case involved a determination that an individual book, which when placed on the shelf implicated first amendment procedural safeguards, would be removed because of its content without any imput from those whose interests would be affected. Like substantive rules themselves, such insensitive selection procedures can chill freedom of expression. The mere vote of a majority of the board, affording no realistic opportunity for those affected to be heard,[75] opens disquieting opportunities for the school board to by-pass normal protective procedures designed to safeguard the rights of students and teachers and thus transgresses first amendment procedural guarantees. Framing the isssue as one of first amendment due process would assimilate the instant decision into the burgeoning body of law which fastens strict procedural requirements on government action aimed at controlling the exer-

74. The usual procedure was to appoint a board committee to make recommendations on textbooks. It would meet with a faculty committee and a citizens' committee to discuss the books recommended by the faculty before making its own recommendations to the full Board.

75. Resolutions reflecting general school board policies of selection without regard to specific books are usually legislative in nature, are subjected to limited review, and may only be attacked on constitutional grounds for an arbitrary abuse of authority. On the other hand, a determination that the status of a single book should be changed is usually a judicial exercise. Those safeguards employed in adjudicatory proceedings should likewise be employed here. City of Eastlake v. Forest City Enterprise, Inc., Civil No.74-1563 (6th Cir., decided June 21, 1976).

cise of free expression[76] and would avoid the controversy created by predicating a claim on substantive first amendment protections.

The instant court, however, did address the substantive constitutional implications of removal of existing texts from the library shelf while avoiding the tangential and confusing issue of who is the proper textbook selector. The decision would have been more helpful had the court articulated the reason for the different implications involved in refusal to purchase a book and removal of a book from a library shelf. Obviously, both decisions can be related to content and both may tend to chill classroom discussion of ideas contained in the books. Selection of books to be shelved, however, requires choosing from an infinite variety of books since no public high school facility has the cataloguing staff, the space, or the budget to carry more than a fraction of published works that might be mentioned in class. Employing content as one of many criteria in textbook selection is different from adopting content as the sole basis for excising a particular book. The countervailing government interests—scarce funds, limited personnel, and restricted space—that outweigh the constitutional interests of students in a book selection situation disappear when school officials remove a particular book merely because its content is offensive to their personal tastes. The absence of these legitimate budgetary interests on the part of the state tips the scales in favor of student rights, which preclude state efforts to regulate protected expression under the guise of its authority to make textbook selections.

M. CAROLYN BAREFIELD

## Constitutional Law—Search and Seizure—Federal Courts Are Bound by Federal Wiretapping Statutes and Will Not Exclude Evidcnce Seized by State Agents in Violation of More Restrictive State Laws

### I. FACTS AND HOLDING

Defendant appealed her federal conviction for possession of heroin[1] on the ground that the trial court erred in denying her motion

76. *See generally* Monaghan, *First Amendment "Due Process,"* 83 HARV. L. REV. 518 (1970).

1. 21 U.S.C. § 844(a) (1970) prohibits knowing or intentional possession of a controlled substance.

to suppress evidence seized by California police in violation of state law.[2] Federal agents had procured information regarding a narcotics sale[3] through a wiretap authorized pursuant to Title III of the Omnibus Crime Control and Safe Streets Act of 1968.[4] Although California law prohibits wiretapping and the use of its fruits in any way,[5] this information was delivered to California state police and led to the arrest of defendant and seizure of the evidence.[6] Defendant contended that evidence seized by state agents in the course of a search conducted in violation of state wiretapping law is not admissible in federal criminal proceedings even though the seizure may satisfy the Constitution and federal statutory requirements.[7] The government, with whom the district court agreed, argued that federal courts should apply federal standards when considering the admissibility of evidence and should not be bound by more restrictive state statutes. On appeal to the Ninth Circuit Court of Appeals sitting *en banc, held,* affirmed. Although state law may prohibit wiretapping and state courts may exclude evidence obtained by such practices, federal courts are not bound by the more restrictive state statutes and may admit all evidence not seized in violation of the Constitu-

2. Defendant alleged that the arrest, search, and seizure were all fruits of an unlawful wiretap. *See* note 7 *infra* and accompanying text.

3. Federal agents had learned through wiretaps that the target of their investigation, James Kilpatrick Cooper, was planning to make a narcotics purchase and then drive from Los Angeles to Fresno with a female companion, who turned out to be defendant.

4. 18 U.S.C. §§ 2510-20 (1970). 18 U.S.C. § 2516(1) (1970) provides for the interception of oral and wire communications by federal agents. The court did not question the validity of the wiretaps under federal law because that issue had been decided previously in United States v. Turner, 528 F.2d 143 (9th Cir.), *cert. denied,* 423 U.S. 996 (1975).

5. CAL. PENAL CODE § 631 (West 1970) provides in part:

> (a) **Prohibited acts; punishment; recidivists.** Any person who . . . intentionally taps, or makes any unauthorized connection . . . with any telegraph or telephone wire . . . or who uses, or attempts to use, in any manner, or for any purpose, or to communicate in any way, any information so obtained . . . is punishable by a fine . . . or by imprisonment . . . or by both . . . .
>
> . . . .
>
> (c) **Evidence.** Except as proof in an action or prosecution for violation of this section, no evidence obtained in violation of this section shall be admissible in any judicial . . . proceeding.

6. State police, having received this information from the federal agents and acting without a warrant, stopped Cooper's car in Fresno and asked the occupants to step out. One of the officers detected an acetic odor emanating from defendant's purse, and a subsequent search revealed narcotics paraphernalia and 51 grams of heroin. This evidence was introduced at defendant's trial over her objection.

7. This argument was two-pronged: the actions of the state police should be judged on the hasis of the more restrictive state wiretapping law rather than on the provisions of Title III, and alternatively, if federal law is applied, the court should extend the scope of the exclusionary rule to cover evidence seized by state agents in violation of state law. This second contention focused on the illegality of the wiretap under the state statute and argued that state officials cannot use the fruits of such a wiretap regardless of federal standards.

tion or applicable federal statutes. *United States v. Hall,* No. 73-2826 (9th Cir., Aug. 31, 1976).

## II. LEGAL BACKGROUND

In *Weeks v. United States*[8] the Supreme Court first announced that federal courts must exclude evidence obtained by federal officers in violation of the fourth amendment.[9] In that case, however, the Court permitted federal courts to continue to admit evidence unconstitutionally seized by state officers and turned over to federal agents.[10] The Court subsequently narrowed the scope of this "silver platter doctrine" in *Lustig v. United States*[11] by holding that when the combined efforts of state and federal agents produce an unconstitutional search and seizure, the fruits of that activity are subject to the federal exclusionary rule. Finally, in *Elkins v. United States,*[12] the silver platter doctrine was struck down in its entirety. In *Elkins* the Court declared that the doctrine is incompatible with fourth amendment guarantees and undermines state and federal policies of assuring obedience to the Constitution by law enforcement officers.[13] This policy concern was justified especially in those states that already had adopted the exclusionary rule because their efforts to exclude illegally seized evidence were being frustrated by the admission of this evidence in federal proceedings.[14] Thus the Court expressed a concern for both of the traditional justifications for the exclusionary rule: the deterrent effect of the rule and the integrity of the courts.[15] The Court has been reluctant to extend the exclusion of silver platter evidence to evidence seized by agents other than state officers or to proceedings other than federal criminal trials.[16] For instance, in *United States v. Janis*[17] the Court refused to exclude evidence unlawfully seized by a state officer and then levied upon

8. 232 U.S. 383 (1914).

9. The fourth amendment provides that "the right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, sball not be violated . . . ." U.S. CONST. amend. IV.

10. 232 U.S. at 398.

11. 338 U.S. 74 (1949).

12. 364 U.S. 206 (1960).

13. *Id.* at 220-21.

14. *Id.* at 221. The Court found this frustration of the efforts of states that had adopted the exclusionary rule to be "particularly inappropriate and ironic" since the federal courts were impeding efforts by the states to assure compliance with the fourth amendment. *Id.*

15. *Id.* at 221-22.

16. Note, *The New International "Silver Platter" Doctrine: Admissibility in Federal Courts of Evidence Illegally Obtained by Foreign Officers in a Foreign Country,* 2 N.Y.U.J. OF INT'L L. & POL. 280 (1969).

17. 96 S. Ct. 3021 (1976).

by IRS officials for use in a civil tax proceeding. In reaching this decision, the Court only briefly addressed the judicial integrity rationale[18] and then proceeded to find that the deterrence function would not be furthered because of the lack of common interest between state criminal authorities and federal tax officials.[19]

In discussing the exclusionary rule, the *Elkins* Court seemingly attached much importance to the right of the states to establish and promote their own sanctions,[20] but at the same time it declared that federal standards should not be displaced by state law.[21] One year later the exclusionary rule itself was imposed upon the states in *Mapp v. Ohio*.[22] Although one of the goals of *Mapp* was to create some degree of national uniformity,[23] the first Supreme Court case to explain further the *Mapp* rule held that the decision did not preclude the states from developing their own standards regarding arrest, search, and seizure in order to meet "the practical demands of effective criminal investigation and law enforcement."[24] Consistent with this philosophy, California took steps toward eliminating those kinds of searches that had prompted the imposition of the exclusionary rule. On the subject of electronic surveillance, the California Penal Code expressly prohibits interceptions of oral and wire

18. *Id.* at 3034 n.35.

19. *Id.* at 3034.

20. The Court stated that the "question with which we deal today affects not at all the freedom of the states to develop and apply their own sanctions in their own way." 364 U.S. at 221.

21. In closing, the majority stated:

> In determining whether there has been an unreasonable search and seizure by state officers, a federal court must make an independent inquiry, whether or not there has been an inquiry by a state court, and irrespective of how any such inquiry may have turned out. The test is one of federal law, neither enlarged by what one state court may have countenanced, nor diminished by what another may have colorably suppressed.

*Id.* at 223-24.

Justice Frankfurter, dissenting, recognized the potential conflict between state and federal practices and predicted that federal courts would disregard state rules when considering whether to admit evidence seized by state officers. Justice Frankfurter wrote:

> State law seeking to control improper methods of law enforcement is frustrated by the Court's new rule whenever a State which enforces an exclusionary rule places restrictions upon the conduct of its officers not directly required by the Fourth Amendment with regard to federal officers . . . . I cannot think why the federal courts should thus encourage state illegalities.

*Id.* at 245-46. Frankfurter's prediction was in part supported by the Court's holding in a companion case to *Elkins* that was remanded for an evaluation of the admissibility of evidence seized by state agents on the basis of fourth amendment standards. Rios v. United States, 364 U.S. 253 (1960).

22. 367 U.S. 643 (1961). California had adopted the exclusionary rule 6 years before the *Mapp* decision. People v. Cahan, 44 Cal. 2d 434, 282 P.2d 905 (1955).

23. 367 U.S. at 657-58.

24. Ker v. California, 374 U.S. 23, 34 (1963).

communications and excludes from evidence in any judicial proceeding the fruits of all such interceptions.[25]

Congress, in response to pressure from the Supreme Court,[26] enacted Title III of the Omnibus Crime Control and Safe Streets Act of 1968 (Title III) in order to create uniform federal standards for the regulation of electronic surveillance.[27] Title III is not as restrictive as the California law, and it allows the interception of communications pursuant to legally authorized warrants.[28] Several sections of Title III deal directly with state law enforcement officials and state courts, and the legislation as a whole evinces an intent to foster cooperation between federal and state officials.[29] Title III provides for the issuance of wiretap authorizations by state judges to certain state officers "[I]n conformity with section 2518 . . . and with the applicable State statute . . . ."[30] This provision has as its goal the centralization of statewide policy in this area, but Congress envisioned that the state would be permitted to enact more restrictive provisions for the issuance of warrants.[31] Furthermore, Title III authorizes the use and disclosure of information gathered by wiretaps by any investigative or law enforcement officer[32] who by any means authorized by Title III has obtained knowledge of such informa-

25. *See* note 5 *supra*. For a comparative study of the California and federal statutes see Comment, *Electronic Surveillance in California: A Study in State Legislative Control*, 57 CALIF. L. REV. 1182 (1969).

26. *See* Berger v. United States, 388 U.S. 41 (1967), in which the Court struck down the New York wiretap statute and outlined the requirements for a constitutional wiretap statute; Schwartz, *The Legitimation of Electronic Eavesdropping: The Politics of "Law and Order,"* 67 MICH. L. REV. 455, 457-77 (1969).

27. 18 U.S.C. §§ 2510-20 (1970).

28. 18 U.S.C. §§ 2516-19 (1970).

29. The Senate Report on § 2517 provides:

> The proposed provision envisions close Federal, State, and local cooperation in the administration of justice. The utilization of an information-sharing system within the law-enforcement community circumscribed by suitable safeguards for privacy is within the intent of the proposed legislation.

SENATE COMM. ON THE JUDICIARY, OMNIBUS CRIME CONTROL AND SAFE STREETS ACT OF 1967, S. REP. No. 1097, 90th Cong., 2d Sess. 99 (1968) [hereinafter cited as S. REP. No. 1097].

30. 18 U.S.C. § 2516(2) (1970).

31. The Senate Report on § 2516(2) provides:

> No applications [for electronic surveillance] may be authorized unless a specific State statute permits it. The State statute must meet the minimum standards reflected as a whole in the proposed chapter. The proposed provision envisions that States would be free to adopt more restrictive legislation, or no legislation at all, but not less restrictive legislation.

S. REP. No. 1097, *supra* note 29, at 98.

32. 18 U.S.C. § 2510(7) (1970) defines an investigative or law enforcement officer as "[A]ny officer of the United States or of a State or political subdivision thereof, who is empowered by law to conduct investigations of or to make arrests for offenses enumerated in this chapter. . . ."

tion.[33] This power is limited, however, by the caveat that such use or disclosure by an officer must be "appropriate to the proper performance of his official duties."[34]

The effect that the legislative scheme of Title III has had on more restrictive state statutes such as that of California is not entirely clear. The Supreme Court held in *United States v. DiRe*[35] that because there was no relevant federal statute governing warrantless arrests, the federal courts had to rely on the corresponding state statutes.[36] Since that time the Court has reaffirmed the right of the states to impose higher standards in fourth amendment cases than are required by the Constitution.[37] In cases in which there are applicable federal rules, however, federal courts have ruled consistently since *Olmstead v. United States*[38] that when states do impose higher standards, the actions of federal agents shall be judged on the basis of federal law.[39] The Ninth Circuit relied on this principle in deciding in *United States v. Keen*[40] that the propriety of a wiretap conducted by federal officers should be determined by reference to federal law even though the investigations violated the stricter state wiretap laws.[41] When the evidence was illegally seized by state officers, however, the courts have not been as consistent in determining its admissibility. Several circuits have ruled in cases involving the validity of search warrants that when there clearly is no violation by the state officer of the fourth amendment or federal law, more restrictive state procedures will not compel exclusion of evidence by federal courts.[42] Two circuits have held in cases of telephone monitoring by local police that because no federal standards had been violated, exclusion of the evidence in federal courts merely because

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33. 18 U.S.C. § 2517 (1970) provides in part:

(2) Any investigative or law enforcement officer who, by any means authorized by this chapter, has obtained knowledge of the contents of any wire or oral communication or evidence derived therefrom may use such contents to the extent such use is appropriate to tbe proper performance of his official duties.

34. *Id.*; S. REP. No. 1097, *supra* note 29, at 99-100.

35. 332 U.S. 581 (1948).

36. *Id.* at 589; *accord,* Watson v. United States, 96 S. Ct. 820, 826 n.8 (1976). *But see* United States v. Miller, 452 F.2d 731 (10th Cir. 1971), *cert. denied,* 407 U.S. 926 (1972).

37. Cooper v. California, 386 U.S. 58 (1967); Ker v. California, 374 U.S. 23 (1963).

38. 277 U.S. 438 (1928).

39. *Id.* at 468-69; *see* United States v. Russell, 411 U.S. 423 (1973); On Lee v. United States, 343 U.S. 747, 754-55 (1952).

40. 508 F.2d 986 (9th Cir. 1974), *cert. denied,* 421 U.S. 929 (1975).

41. *Accord,* United States v. Armocida, 515 F.2d 49 (3d Cir. 1975), *cert. denied,* 423 U.S. 858 (1976).

42. *See, e.g.,* United States v. Dudek, 530 F.2d 684 (6th Cir. 1976); United States v. Bedford, 519 F.2d 650 (3d Cir. 1975); United States v. Melancon, 462 F.2d 82 (5th Cir.), *cert. denied,* 409 U.S. 1038 (1972); United States v. Sims, 450 F.2d 261 (4th Cir. 1971).

state law would dictate such a result was not necessary.[43] The Second Circuit, on the other hand, has ruled in several instances that state law is controlling on questions of the validity of search warrants and wiretaps employed by state agents.[44] In *United States v. Tortorello*,[45] the court discussed the implications and constitutionality of Title III, but the validity of several features of the state-authorized wiretap and its effect upon the admission of evidence was judged on the basis of state law.

Several state courts have interpreted the provisions of Title III as authorizing states to enact stricter wiretap statutes that will not be preempted by federal law. The California Supreme Court held in *People v. Conklin*[46] that Congress did not intend Title III to preempt the entire field of electronic surveillance, but rather that the legislative intent was to permit states to establish their own standards. Furthermore, the court found that the state wiretap statute did not conflict with Title III merely because each employed different standards in order to accomplish the common purpose of protecting and guaranteeing the privacy of oral and wire communications.[47] For a true conflict to exist, the state law must actually impair the attainment of federal objectives and not merely differ by the degree to which the respective laws seek to protect the right of privacy.[48] Thus states such as California have demonstrated both a clear intent to enact more rigorous wiretap provisions than Congress has seen fit to establish and a belief that such legislation has not been preempted by federal law.[49] If federal courts judge the actions of state agents on the basis of federal law when state and federal wiretapping laws are inconsistent, they could create a new variety of silver platter evidence that would enable state agents to seize

43. United States v. Shaffer, 520 F.2d 1369 (3d Cir. 1975), *cert. denied*, 423 U.S. 1051 (1976); United States v. Neville, 516 F.2d 1302 (8th Cir. 1975).

44. *See* United States v. Capra, 501 F.2d 267 (2d Cir. 1974), *cert. denied*, 420 U.S. 990 (1975); United States v. Manfredi, 488 F.2d 588 (2d Cir. 1973), *cert. denied*, 417 U.S. 936 (1974).

45. 480 F.2d 764, 777-78, 781-83 (2d Cir.), *cert. denied*, 414 U.S. 866 (1973).

46. 12 Cal. 3d 259, 522 P.2d 1049, 114 Cal. Rptr. 241, *appeal dismissed for want of substantial federal question*, 419 U.S. 1064 (1974).

47. *Id.* at 269-70, 522 P.2d at 1055-56, 114 Cal. Rptr. at 247-48.

48. *Id. See also* People v. Howard, 55 Cal. App. 3d 373, 127 Cal. Rptr. 557 (1976); People v. Carrington, 40 Cal. App. 3d 647, 115 Cal. Rptr. 294 (1974); People v. Jones, 30 Cal. App. 3d 852, 106 Cal. Rptr. 749, *appeal dismissed for want of substantial federal question*, 414 U.S. 804 (1973); 14 SANTA CLARA LAW. 159 (1973). *But see* People v. Mahoney, 47 Cal. App. 3d 699, 122 Cal. Rptr. 174 (1975).

49. Several other states are in agreement; *see, e.g.*, State v. Farha, 218 Kan. 394, 544 P.2d 341 (1975); State v. Siegel, 266 Md. 256, 292 A.2d 86 (1972); Commonwealth v. Vitello, 327 N.E.2d 819 (Mass. 1975); People v. Warner, 65 Mich. App. 267, 237 N.W.2d 284 (1975).

evidence in violation of state law and transfer it to federal agents for use in federal prosecutions. The possibility of establishing such a double standard for state agents is present in the instant case, and it provides the federal court with the question whether to honor the intention of the state to impose stricter standards upon its own law enforcement officers than Title III requires.

## III. The Instant Opinion

The instant court recognized that although the wiretaps were authorized by federal law, California does not permit wiretapping and its courts would have excluded the fruits of the search. The court acknowledged that in many instances *United States v. DiRe*[50] compels federal courts to adopt state standards, but held the *DiRe* doctrine inapposite on two independent grounds: Title III provided the applicable federal statute that was not present in *DiRe*, and the instant case, unlike *DiRe*, concerned the admissibility of evidence rather than the quantity of evidence necessary to establish probable cause.[51] Thus concluding that *DiRe* was not dispositive, the court decided that the propriety of the search and seizure must be judged by reference to the controlling federal law. In so deciding, the court rejected defendant's contentions that the controlling federal statute allowed preemption by state law or that it was inapplicable to the instant case because the state agents had exceeded the scope of their official duties in violation of Title III.[52] After noting that to the extent federal and state law conflict, the Supremacy Clause[53] directs it to adhere to federal law, the court stated that Congress would have provided explicitly that Title III be preempted by more restrictive state law if it had so intended. Moreover, the court determined that Title III did not adopt state law as the test of "proper performance of . . . official duties," but that federal courts should focus upon the reasonableness of the dissemination of the information gathered by the wiretaps.[54] The court was satisfied that the state agents had acted reasonably in turning the evidence over to federal agents for use in a federal prosecution because possession of heroin is both a federal offense and a felony under state law, and the state

50. 332 U.S. 581 (1948).

51. United States v. Hall, No. 73-2826, slip op. at 4, 6-8 (9th Cir., Aug. 31, 1976).

52. The defendant's argument was based on 18 U.S.C. § 2517(2) (1970). *See* notes 33 & 34 *supra* and accompanying text.

53. The Supremacy Clause provides that the "Constitution, and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and tbe Judges in every State shall be bound thereby . . . ." U.S. Const. art. VI.

54. United States v. Hall, No. 73-2826, slip op. at 7-8 (9th Cir., Aug. 31, 1976).

officers did have reasonable cause to believe that defendant had committed a felony.[55] The court thus concluded that the state agents had performed their official duties properly and that the provisions of Title III had not been violated.

Having freed itself from the restrictive state statute, the court was left with the narrow question whether evidence seized by state agents in violation of state law should be excluded from federal proceedings on policy grounds. Relying on *United States v. Keen*,[56] the court decided that the trial court had not erred by admitting the disputed evidence. The court recognized that *Keen* was concerned solely with federal agents and was distinguishable from the instant case. Nevertheless, it adopted the view expressed in *Keen* that "the exclusionary rule is a remedy which is integrally bound up with constitutional protections . . . and . . . [the court is] not necessarily bound to extend it to evidence tainted under stated law."[57] The court concluded that as long as the actions of the state agents satisfied constitutional and federal statutory requirements, a violation of state law does not render evidence inadmissible in a federal criminal proceeding.[58]

The dissenting judges stated that the majority, by refusing to extend the exclusionary rule, had endorsed the type of double standard for state agents struck down in *Elkins*.[59] The dissent found that the admission of evidence seized in violation of state law was as serious a compromise of federal judicial integrity as would be a ratification of a violation of the fourth amendment itself. By focusing upon legislative intent,[60] the dissent concluded that Congress had encouraged the states to enact their own wiretapping provisions and that the Supremacy Clause was not operative since the California provisions actually furthered rather than conflicted with the goals of Title III. Furthermore, the dissent felt that federal standards should not be controlling since the state police, by violating state law, were no longer performing their official duties as required by Title III.[61] The dissent thus concluded that the state wiretapping statute was controlling and that Congress had not intended that the

55. *Id.*

56. *See* note 40 *supra* and accompanying text.

57. United States v. Hall, No. 73-2826, slip op. at 8-9 (9th Cir., Aug. 31, 1976).

58. A concurring opinion did not reach the merits because it found defendant not to have standing to object under Title III. The concurring judge found that defendant was not an "aggrieved" party to the wiretap as required by 18 U.S.C. § 2518(10)(a) (1970).

59. *See* notes 12-15 *supra* and accompanying text.

60. *See* notes 29 & 31 *supra*.

61. *See* notes 32-34 *supra* and accompanying text.

close federal-state cooperation solicited by Title III be transformed into a federal power to " 'conscript' into federal employ the officers of unwilling states such as California."[62]

## IV. COMMENT

The instant case reflects two recent developments in the law of search and seizure, but the court failed to place appropriate emphasis upon these developments in order to analyze fully the issues presented by the case. The first development concerns the conflict between federal and state law over the procedures that their respective law enforcement officers may follow in searching for and securing evidence and consists of a reversal of the conditions that prompted the *Elkins* and *Mapp* decisions. In those cases the Supreme Court imposed the exclusionary rule on evidence seized by state officers in violation of the fourth amendment because the states had failed to enact their own sanctions. In the instant case, however, the court was faced with the question whether procedures and evidence not available to state agents at the state level should be authorized in federal proceedings. Although the court recognized this dichotomy between state and federal law, it did not address the inconsistency presented by the ability of state agents to secure evidence in a manner expressly forbidden by state law, and yet avoid state sanctions[63] by transferring the evidence to federal authorities for use in federal proceedings. The second development is a trend in the federal courts to refuse to extend the exclusionary rule or to discuss the implications that a refusal to extend the rule may have in terms of judicial integrity. As *United States v. Janis*[64] indicates, the rationale of judicial integrity that formerly served as a justification for the exclusionary rule has fallen into disfavor.[65] Presently, the federal courts are concerned primarily with a deterrence rationale,[66] but even this feature did not appear in the court's analysis. Instead the court relied on the general proposition that the exclusionary rule is bound up with fourth amendment guarantees and therefore should not be applied to violations of state law not rising to constitutional proportions.

62. United States v. Hall, No. 73-2826, slip op. at 18 (9th Cir., Aug. 31, 1976).

63. Arguably, if the state did wish to enforce its wiretap ban against its police officers, it could punish them through the criminal provisions of its penal code rather than rely on the sanction of the exclusionary rule. *See* note 5 *supra*.

64. 96 S. Ct. 3021 (1976).

65. *See* notes 17-19 *supra* and accompanying text.

66. *See* notes 17-19 *supra* and accompanying text.

The analysis adopted by the majority concealed the actual importance of the two developments. As the dissent pointed out, much of the majority's discussion of the *DiRe* doctrine was unnecessary because Title III furnished the applicable federal statute that was absent in *DiRe*.[67] The two major questions that were raised by the defendant and should have been discussed by the court were whether Congress intended that Title III preempt the entire field of electronic surveillance, and whether the exclusionary rule should be extended to encompass evidence seized by state agents in violation of state law. A strong argument can be made that the legislative history of Title III reveals an intention to incorporate state law as far as state agents are concerned.[68] Thus, even though the court may have been correct in asserting that the propriety of the wiretaps should be judged on the basis of federal law, there remains the possibility that the authors of the federal law contemplated that the actions of state agents would still be governed by state provisions as long as those provisions did not violate the federal law. Moreover, the limitation that section 2517 places on the use and disclosure of information gathered through electronic surveillance by state officers[69] would seem to indicate that a state officer, in performing his official duties, could only act within the constraints that his state has erected for him. The majority defined this limitation not in terms of state requirements, however, but in terms of general standards of probable cause and reasonable dissemination of the contents of interceptions. Thus the court has provided state police with a different set of official duties than they normally would have to follow when bringing matters before state courts. The theory that the scope of the exclusionary rule should not be extended is not inconsistent with the language in *Elkins*[70] and the line of cases beginning with *Olmstead v. United States*[71] that refused to apply state standards to the actions of federal agents.[72] The court's reliance on *United States v. Keen*[73] in this analysis seems somewhat suspect, however, because *Keen* reviewed the actions of federal agents only and did not discuss the issue of the relationship between state agents and federal courts presented by the instant case.[74] In fact all

67. *See* notes 35 & 36 *supra* and accompanying text.
68. *See* notes 29-34 *supra* and accompanying text.
69. *See* notes 32-34 *supra* and accompanying text.
70. *See* note 21 *supra.*
71. 277 U.S. 438 (1928).
72. *See* text accompanying notes 38 & 39 *supra.*
73. 508 F.2d 986 (9th Cir. 1974), *cert. denied,* 421 U.S. 929 (1975).
74. *See* notes 40 & 41 *supra* and accompanying text.

of these decisions are distinguishable from the instant case because they were directed to the actions of federal agents, and the policy reasons for applying state law to state agents are not as compelling when the actions of federal agents have been called into question. Moreover, the policy grounds that supported the abandonment of the silver platter doctrine in *Elkins,* such as the avoidance of frustration of state policy by federal courts and the need to prevent "subterfuge and evasion with respect to federal-state cooperation," are equally relevant in the instant case,[75] though they were not discussed by the court.

The potentially substantial impact of the instant decision on the relationship between federal and state criminal justice systems is subject to limitation because it rests primarily on statutory interpretation, and Congress could clarify its intentions with regard to Title III. Furthermore, the Supreme Court has not yet ruled on the constitutionality of Title III and changes could be imposed by the judiciary in the future. As the law now stands, however, the decision could present serious difficulties for state law enforcement authorities. The Ninth Circuit now permits federal courts to assess the actions of state officers in terms of federal law, and it refuses to extend the scope of the exclusionary rule to aid the states in controlling the practices of their agents despite attempts by the states to impose more rigorous standards on their officers. Thus the condition that prompted the abandonment of the silver platter doctrine in *Elkins* once again has become apparent: a state agent can seize evidence in violation of his state's laws and yet avoid the state's exclusionary rule by handing the evidence over to federal agents. This result will dilute the effectiveness of the state's exclusionary rule, and as the instant case demonstrates, such dilution can encourage state officers to obtain evidence through practices expressly forbidden by state law. The court therefore should have considered the effect that its ruling may have on the ability of the states to insure that their officers abide by state law and the prescribed standards of police practice. In essence this conflict between federal and state law focuses on the same arguments that were debated in *Elkins* and in all recent cases in which the exclusionary rule was in issue. These arguments are whether the exclusionary rule actually deters unlawful police behavior, whether there are alternative means of assuring obedience to state law without risking the loss of evidence of criminal activity, and whether the courts have a respon-

75. *See* notes 12-15 *supra* and accompanying text.

sibility to exclude credible evidence that was obtained in an unlawful manner. These issues call into question the basic rationales of the exclusionary rule, and the failure of the Ninth Circuit to address them places the states in the awkward position of not knowing exactly what effect Title III has had on their more restrictive laws or how much cooperation they should encourage between their officers and federal agents. As these conditions persist, it will become increasingly important for the federal courts to define clearly what role state law enforcement officers are meant to play under the provisions of Title III, as well as to make a definitive statement on the future scope and viability of the exclusionary rule. As long as the federal courts fail to respond to these basic issues, the questions presented by the instant case concerning the relationship between state and federal criminal justice systems and the double standard provided to state officers will also remain unresolved.

ROBERT S. REDER

# Securities Regulation—Definition of "Security"—Promissory Notes With Maturities Exceeding Nine Months Are Presumed to Be Securities Under the 1934 Act Unless Issued in a Context Closely Resembling One of Six Examples of Commercial Transactions

## I. FACTS AND HOLDING

Plaintiff bank purchased from a brokerage firm[1] three unsecured long-term[2] promissory notes,[3] which became worthless when

1. The brokerage firm, Weis, Voisin & Co., Inc., later known as Weis Securities, was a member of the New York and American Stock Exchanges. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1128 (2d Cir. 1976).

2. As used herein, "long-term note" means any note that matures more than 9 months after issuance. Notes maturing in shorter periods will be referred to as "short-term notes." *See* note 25 *infra*.

3. The notes had an aggregate value of approximately $1 million and were subordinated to claims by Weis's general creditors plus two other unsecured creditors that held similar notes worth $4 million. The notes were payable 12, 15, and 18 months after their issuance date of July 31, 1972, but only if Weis had heen given 6 months prior written notice. Interest was payable after each note matured at a rate 3% in excess of the prime commercial loan rate of the lender at maturity but in no event less than 9% per annum. The notes could be transferred by plaintiff only to a party approved by the New York Stock Exchange. The Bank waived any right to setoff as well as the right to take any of Weis's property that might come into its hands as security for the notes.

the firm was placed in receivership. Claiming that the notes were securities and that it had purchased the notes in reliance upon defendant's allegedly false statements[4] regarding the financial condition of the brokerage firm, plaintiff sought damages for violation of section 10(b) of the Securities Exchange Act of 1934.[5] Defendant asserted that because the notes were not offered in the context of an investment they were not securities regulated by the 1934 Act.[6]

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Weis apparently sought the loans to comply with New York Stock Exchange capital requirements, which prohibited a member firm from having "Aggregate Indebtedness" that exceeded 2,000% of its net capital. Since "Aggregate Indebtedness" excludes "liabilities subordinated to general creditors pursuant to a separate agreement approved by the Exchange," Weis was permitted to show the indebtedness to the Bank in the equity section of its financial statements. 544 F.2d at 1128-29.

4. Defendant Touche Ross & Co., Weis's independent auditor, had certified that Weis's financial statement and answers to an SEC questionnaire fairly presented its financial condition and conformed to generally accepted accounting principles. Plaintiff asserted that Touche Ross knew or should have known that the Weis financial statements were false and misleading in many respects. *Id.* at 1128.

5. Section 10(b) of the Securities Exchange Act of 1934 [hereinafter cited as the 1934 Act], 15 U.S.C. § 78j(b) (1970), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . or any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Plaintiff also alleged a violation of rule 10b-5, 17 C.F.R. § 240.10b-5 (1976), which provides:

> It shall be unlawful for any person, directly or indirectly . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Plaintiff further alleged that defendant violated the following sections of the 1934 Act: § 15 (c), 15 U.S.C. § 78o-3 (Supp. V 1975) (amended 1975) (prohibiting use of the mails to deceive with respect to an over-the-counter security), § 17(a), 15 U.S.C. § 78q(a) (Supp. V 1975) (amended 1975) (requiring proper maintenance and retention of records), and § 18(a), 15 U.S.C. § 78r(a) (1970) (imposing civil liability for those making or causing to be made fraudulent representations in required reports). 544 F.2d at 1127.

Plaintiff also alleged that defendant violated § 17(a) of the Securities Act of 1933 [hereinafter cited as the 1933 Act], 15 U.S.C. § 77q(a) (1970). 544 F.2d at 1127. Section 17(a) is an antifraud provision similar to rule 10b-5, which was created pursuant to § 10(b) of the 1934 Act. Section 17(a) of the 1933 Act has been described as the forerunner of rule 10b-5. 29 VAND. L. REV. 880, 881-82 n.10 (1976), *citing* 35 U. MO. K.C.L. REV. 320, 323 (1967).

6. Touche Ross asserted the same defense to plaintiff's claim under the 1933 Act. 544 F.2d at 1128. The definition of a "security" as "any note" in both the 1933 and 1934 Acts, *see* notes 11 & 25 *infra* and accompanying text, applies "unless the context otherwise re-

Accordingly, defendant moved for dismissal for lack of subject matter jurisdiction.[7] Finding that the note transaction resembled an investment more closely than a commercial loan, the district court[8] denied the motion to dismiss. On interlocutory appeal[9] to the United States Court of Appeals for the Second Circuit, *held,* affirmed. A long-term promissory note is presumed to be a security regulated by section 10(b) of the Securities Exchange Act of 1934 unless the context of the note transaction closely resembles one of six enumerated examples of commercial transactions.[10] *Exchange National Bank v. Touche Ross & Co.,* 544 F.2d 1126 (2d Cir. 1976).

## II. LEGAL BACKGROUND

The Securities Act of 1933 and the Securities Exchange Act of 1934 both define "security" to include "any note."[11] All promisssory notes are not securities, however, because of two provisions common to the 1933 and 1934 Acts.[12] The first provision is the clause "unless the context otherwise requires," which prefaces the definition of a security in both Acts.[13] Although the legislative history of the Acts does not describe clearly the intended scope of the context clause, courts have found that Congress enacted the securities laws to protect investors and often have resorted to the context clause to effect this interpretation.[14] Until the 1970's courts only reluctantly applied

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quires." 1933 Act § 2, 15 U.S.C. § 77b (1970); 1934 Act § 3(a), 15 U.S.C. § 78c(a) (1970). Defendant also relied upon the concurring opinion in Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976), which suggests that any time a bank receives a note in what purports to be an exercise of its lending function the federal securities laws should not apply. 544 F.2d at 1136. *See* text accompanying note 35 *infra.*

7. In its motion defendant also claimed that plaintiff's allegations of fraud were incurably defective. The district court, however, focused on the contention that the notes were not securities within the 1933 or 1934 Acts. 544 F.2d at 1128. Lack of subject matter jurisdiction would have caused dismissal because there was no diversity of citizenship. *Id.*

8. The United States District Court for the Southern District of New York tried the case after its transfer from the United States District Court for the Northern District of Illinois under 28 U.S.C. § 1404(a) (1970). 544 F.2d at 1127.

9. The district court certified its finding for interlocutory appeal under 28 U.S.C. § 1292(b) (1970).

10. *See* text accompanying note 54 *infra.*

11. 1933 Act § 2(1), 15 U.S.C. § 77b(1) (1970); 1934 Act § 3(a)(10), 15 U.S.C. § 78c(a)(10) (1970).

12. Numerous other exclusionary provisions exist that were not in issue in the instant case.

13. 1933 Act § 2, 15 U.S.C. § 77b (1970); 1934 Act § 3(a), 15 U.S.C. § 78c(a) (1970).

14. Although the Supreme Court has not considered the question of which promissory notes are securities, it has encouraged a broad and flexible interpretation of the Acts based on the "economic realities" of the transaction and thus has emphasized the context of the transaction in which the alleged security was created. United Housing Foundation, Inc. v. Forman, 421 U.S. 837, *rehearing denied,* 423 U.S. 884 (1975) (holding shares of "stock" in a

the context clause to limit the provision that "security" includes "any note."[15] Recent appellate decisions, however, have emphasized the "context" more than the "any note" language and have held that notes were securities when the notes formed a part of investment transactions.[16] In addition to the congressional intent to protect investors, the recent decisions have considered the impracticality of subjecting all promissory notes to federal regulation[17] and have hesitated to give effect to apparently inconsistent provisions of the 1933 and 1934 Acts.[18] To determine which notes are part of investment transactions, recent decisions have developed an approach labelled the "commercial-investment dichotomy" analysis,[19] which balances facts suggesting that the note was part of a commercial

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housing cooperative were not "securities"); Tcherepnin v. Knight, 389 U.S. 332 (1967) (withdrawable share in savings and loan association held a "security"); SEC v. W.J. Howey Co., 328 U.S. 293 (1946) (sale of parcels of a citrus grove development with a management contract held to be sale of regulated investment contracts); SEC v. C.M. Joiner Leasing Corp., 320 U.S. 344 (1943) (oil and gas leases held regulated investment contracts); *see* Comment, *Commercial Notes and Definition of "Security" Under the Securities Exchange Act of 1934: A Note is a Note is a Note?*, 52 NEB. L. REV. 478, 487-88 (1973).

Seeking passage of the Securities Act of 1933, President Roosevelt said in his message to Congress of March 29, 1933, S. REP. No. 47, 73d Cong., 1st Sess. 6-7 (1933) and H.R. REP. No. 85, 73d Cong., 1st Sess. 1-2 (1933), *quoted in* 1 L. LOSS, SECURITIES REGULATION 127 (2d ed. 1961):

> The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business.
>
> This is but one step in our broad purpose of protecting investors and depositors . . . .
>
> What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others.

15. For discussions of the cases, see Hammett, *Any Promissory Note: The Obscene Security—A Search for the Non-Commercial Investment*, 7 TEX. TECH. L. REV. 25 (1975); Lipton & Katz, *"Notes" Are Not Always Securities*, 30 BUS. LAW. 763 (1975); Note, *Status of the Promissory Note Under the Federal Securities Laws*, 1975 ARIZ. ST. L.J. 175, 184 (1975); Comment, *supra* note 14.

16. *See, e.g.*, Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Lino v. City Investing Co., 487 F.2d 689 (3d Cir. 1973) (holding notes were not securities because they were sold in a commercial context); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795 (2d Cir.), *cert.denied*, 414 U.S. 908 (1973). Commentators have disputed convincingly tbe use of "investment" as the test for a "security." *See* Hammett, *supra* note 15 at 59-61, 61 n.162, *citing* Long, *Interpreting the Statutory Definitions of a Security: Some Pragmatic Considerations*, 6 ST. MARY'S L.J. 96, 108 (1974).

17. Zabriskie v. Lewis, 507 F.2d 546, 551 (10th Cir. 1974).

18. *See* notes 25 & 26 and text accompanying note 26 *infra*. Ignoring the context clauses of both Acts would cause the 1933 Act's antifraud provisions to apply to all notes and the nearly identical provisions of the 1934 Act to apply only to long-term notes. Exchange Nat'l Bank v. Touche Ross & Co., 544 F.2d 1126, 1132-33. (1976).

19. C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975); Bellah v. First Nat'l Bank, 495 F.2d 1109 (5th Cir. 1974).

transaction against facts suggesting that the note supported an investment. Although they have agreed that a balancing analysis is appropriate because neither Congress nor the Supreme Court has provided more objective guidelines,[20] the appellate courts have used substantially different criteria to identify an investment.[21] The courts also have differed in the weight that they give to criteria such as risk to initial investment,[22] which party initiated the transaction,[23] and the dollar amount of the note.[24] The second provision limiting the "any note" definition of "security" provides for nonregulation of notes that mature nine months or less after issuance,[25] with the exception that short-term notes remain subject to the antifraud provisions of the 1933 Act.[26] Legislative history indicates that the short-term note exemption under the 1933 Act was intended to be rather narrow, applying only to high-quality notes that could be discounted at Federal Reserve banks;[27] the scope of the exclusion

20. *See, e.g.*, C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1357 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); McClure v. First Nat'l Bank, 497 F.2d 490, 495 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975).

21. *Compare* Zabriskie v. Lewis, 507 F.2d 546 (10th Cir. 1974) (adopting the 8 criteria in Comment, *supra* note 14, at 511-23), *with* Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (setting forth a different set of criteria).

22. Great Western Bank & Trust v. Kotz, 532 F.2d 1252 (9th Cir. 1976) (risk a central consideration under tbe "commercial-investment dichotomy" analysis).

23. *Compare* Great Western Bank & Trust v. Kotz, 532 F.2d 1252, 1258 n.5 (identifying who provided the impetus to the transaction held to be "of little significance"), *with* C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975) (suggesting that identifying who provided the impetus is determinative under the "commercial-investment dichotomy" analysis).

24. Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971) (per curiam opinion holding two notes to be securities essentially because of their face value (over $9 million) and long term (20 years)).

Detailed discussions of when a note should be considered a security under the context clauses of the Acts are located in: Coffey, *The Economic Realities of a "Security": Is There a More Meaningful Formula?*, 18 CASE W. RES. L. REV. 367 (1967); Hannan & Thomas, *The Importance of Economic Reality and Risk in Defining Federal Securities*, 25 HASTINGS L.J. 219 (1974); Long, *An Attempt to Return "Investment Contracts" to the Mainstream of Securities Regulation*, 24 OKLA. L. REV. 135 (1971); Comment, *supra* note 14.

25. Under the 1933 Act, § 2(1) provides that any note is a security, and § 3(a)(3) exempts from the Act's registration and prospectus requirement notes maturing in 9 months or less. These short-term notes are excluded from the definition of a security by § 3(a)(10) of the 1934 Act: "The term 'security' means any note . . . but shall not include . . . any note . . . which has a maturity at the time of issuance of not exceeding nine months . . . ." "Exclusion" will be used hereafter to refer simultaneously to exemption under the 1933 Act and exclusion under the 1934 Act.

26. 1933 Act §§ 12(2), 17(c), 15 U.S.C. §§ 77l(2), 77q(c) (1970). For an explanation of the significance of the different treatment of short-term notes, see note 18 *supra* and accompanying text.

27. This point is discussed thoroughly in Comment, *The Commercial Paper Market and the Securities Acts*, 39 U. CHI. L. REV. 362, 380-85 (1972). The Federal Reserve Board encouraged the short-term note exemption, which was not included in the original draft of § 3(a)(3),

under the 1934 Act has been equated to the scope of the 1933 Act exemption.[28] Recent emphasis on the context of note transactions has reduced greatly if not eliminated the impact of the short-term note exclusion of the 1934 Act.[29] The Fifth Circuit, for example, has held that certain short-term notes were securities in one case[30] and that a long-term note was not a security in another case.[31]

The majority opinion in a recent Ninth Circuit case, *Great Western Bank & Trust v. Kotz*,[32] typifies recent judicial trends by using a "commercial-investment dichotomy" analysis to hold that

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*Id.* at 381-82 & nn. 140-41. A letter to Sen. Duncan U. Fletcher from Chester Morrill, Secretary, Federal Reserve Board, stated that the Board felt that the Act was not intended to be applied to bankers' acceptances or short-term paper issued for the purpose of obtaining funds for current transactions. *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. 94-95, 120 (1933).

Securities Act Release No. 4412 (Sept. 20, 1961), an advisory opinion, stated in part:

> The legislative history of the [1933] Act makes clear that § 3(a)(3) applies only to prime quality negotiable paper of a type not ordinarily purchased by the public, that is, paper issued to facilitate well-recognized types of current operational business requirements of a type eligible for discounting by Federal Reserve banks.

Perhaps the strongest indication of the intended narrow scope of the exemption is a statement in the House Report on the Act, which explains that § 3(a)(3) was intended to apply to "short-term paper of the type available for discount at a Federal Reserve bank and of a type which is rarely bought by private investors." H.R. REP. No. 85, 73d Cong., 1st Sess. 15 (1933).

28. Because the exemption under § 3(a)(3) of the 1933 Act also requires that the funds arise out of a current transaction or that proceeds he used for a current transaction, it was unclear whether the narrow scope of the short-term note exemption of the 1933 Act could also be attributed to the exclusion found in § 3(a)(10) of the 1934 Act. Recent decisions, however, have disregarded the difference in language. C.N.S. Enterprises v. G. & G. Enterprises, Inc., 508 F.2d 1354, 1356-58 (7th Cir.), *cert. denied*, 423 U.S. 825 (1975); Zabriskie v. Lewis, 507 F.2d 546, 550 (10th Cir. 1974); Zeller v. Bogue Elec. Mfg. Corp., 476 F.2d 795, 800-01 (2d Cir.), *cert. denied*, 414 U.S. 908 (1973); Anderson v. Francis I. du Pont & Co., 291 F. Supp. 705, 708 (D.C. Minn. 1968).

29. The short-term note exemption in § 3(a)(3) of the 1933 Act also has been weakened vis-à-vis the context clause in § 2 of the 1933 Act because the scope of the exclusionary provisions of the 1933 and 1934 Acts have been held virtually identical. *See* note 28 *supra*.

30. SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974) (held notes were securities under both the 1933 and 1934 Acts); *accord*, Zabriskie v. Lewis, 507 F.2d 546, 550-52 (10th Cir. 1974); Sanders v. John Nuveen & Co., 463 F.2d 1075 (7th Cir.), *cert. denied*, 409 U.S. 1009 (1972), *commented in* 26 VAND. L. REV. 874 (1973).

31. McClure v. First Nat'l Bank, 497 F.2d 490 (5th Cir. 1974), *cert. denied*, 420 U.S. 930 (1975), *commented in* 35 LA. L. REV. 570 (1975). The McClure opinion stated, "Thus, the investment or commercial nature of a note entirely controls the applicability of the Act, depriving of all utility the exemption based on maturity-length." 497 F.2d at 495. For a criticism of federal court analysis of the note problem, see Hammett, *supra* note 15, at 74 (criticizing the "commercial-investment dichotomy" analysis and the inability of the courts to formulate a better analysis for applying the 1933 and 1934 Acts); Tew & Freedman, *In Support of SEC v. W.J. Howey Co.: A Critical Analysis of the Parameters of the Economic Relationship Between an Issuer of Securities and the Securities Purchaser*, 27 U. MIAMI L. REV. 407 (1973).

32. 532 F.2d 1252 (9th Cir. 1976).

the long-term notes there in question were not securities. Setting forth its own criteria in attempting to define "security" under the 1934 Act,[33] the *Kotz* court noted that no single criterion was determinative and that future cases might require consideration of criteria other than those enumerated.[34] The concurring opinion in *Kotz* proposed a new test: any note received by a bank in the exercise of its lending function should not be treated as a security under the Acts. This test was based on the ability of banks to obtain full disclosure from prospective borrowers and on banks' stronger bargaining position. The concurring opinion further asserted that Congress did not intend to include commercial financing within the protection of the 1933 or 1934 Acts.[35]

The proposed A.L.I. Federal Securities Code contains several provisions indicating when a note is a security. First, the Code retains the context clause preface to the definition of a security.[36] Professor Loss, the Reporter, stated that the problem of determining which notes are securities "does not lend itself to precise statutory solution"[37] and preserved the "context" language to invite "sound judicial discrimination."[38] Secondly, section 297(b)(3) excludes from the definition of a security a note issued in a "mercantile transaction."[39] The comment to section 297(b)(3) indicates that "mercantile transaction" was designed to solve the troublesome commercial-investment dichotomy.[40] The Code, however, does not define "mercantile transaction," a term that would have to be interpreted by the courts. Thirdly, the Code exempts from its registration provisions, but not from its antifraud provisions,[41] "commercial paper,"[42] which is defined to include demand notes and short-term

33. The criteria were: (1) time, (2) collateralization, (3) form of obligation, (4) circumstances of issuance, (5) relationsbip between amount borrowed and size of borrower's business, and (6) contemplated use of the proceeds of the note. *Id.* at 1257-58.

34. Two more recent decisions also used a commercial-investment dichotomy analysis to hold that long-term notes were not securities. Emisco Indus., Inc. v. Pro's, Inc., [1976] CCH FED. SEC. L. REP. ¶ 95,761 (7th Cir. Oct. 29, 1976); Tri-County State Bank v. Hertz, [1976] CCH FED. SEC. L. REP. ¶ 95,772 (M.D. Pa. May 20, 1976).

35. 532 F.2d at 1260-62 (Wrigbt, J., concurring).

36. ALI FED. SEC. CODE § 201(a) (Tent. Draft No. 1, 1972). The Code slightly varies the wording: "unless the context requires otberwise . . . ."

37. *Id.* (Comment).

38. *Id.*

39. ALI FED. SEC. CODE § 297(b)(3) (Reporter's Revision of Text of Tent. Drafts Nos. 1-3, 1974) [hereinafter cited as RD 1-3].

40. *Id.* at note 2.

41. The Code adopts the approach found in the 1933 Act by not exempting short-term notes from its antifraud provisions.

42. Only commercial paper in denominations of $100,000 or more is exempted. RD 1-3, *supra* note 39, § 301(l).

notes.[43] In the absence of more precise federal securities laws or Supreme Court guidance, federal courts continue to struggle with the context clause, at times applying it in derogation of more explicit provisions such as those apparently precluding regulation of many short-term note transactions under the 1933 and 1934 Acts.

## III. The Instant Opinion

Before proposing its own test for determining when a note is a security the instant court discredited two other tests.[44] The court gave three reasons why the "commercial-investment dichotomy" analysis[45] used in previous cases was inadequate. First, the court criticized the criteria used by most courts as being subject to numerous exceptions.[46] Secondly, the dichotomy analysis does not assign relative weights to the criteria to be used by the district courts to determine when a note is a security. Thirdly, the court found that the list of relevant criteria to be applied might vary depending on the facts of each case.[47] The instant opinion concluded that an analysis using dubious criteria in unpredictable combinations provides little assistance to district courts or to counsel.[48]

Having discounted the "commercial-investment dichotomy" analysis, the court considered the proposition in the *Kotz* concurring opinion that notes received by banks in the exercise of their lending function should not be regulated by the 1933 or 1934 Acts.[49] Noting that the securities laws were intended for the protection of the borrower as well as the lender,[50] the instant court found that

43. *Id.* § 216A.

44. Criticism of the "commercial-investment dichotomy" analysis was preceded by discussions of the inconsistent scopes of the 1933 and 1934 antifraud provisions, *see* notes 18 & 26 *supra,* the legislative history of the Acts, and a description of recent appellate decisions dealing with the issue of when a note is a security. The opinion attributed the short-term note exemption in § 3(a)(3) of the 1933 Act to a Federal Reserve Board letter to the Chairmen of the House and Senate Committees considering the Act. *See* note 27 *supra.* The court also indicated that the lack of legislative history for the 1934 Act exclusion in § 3(a)(10) made it unclear whether the omission of the "current transaction" clause of § 3(a)(3) of the 1933 Act was intended to vary the scope of § 3(a)(10) of the 1934 Act from the scope of § 3(a)(3) of the 1933 Act. The court noted that recent appellate decisions recognized that Securities Act Release No. 4412 (Sept. 20, 1961) had "at least some application" to § 3(a)(10) of the 1934 Act, 544 F.2d at 1134.

45. *See* text accompanying notes 21-24 *supra.*

46. For example, the court discredited the investment of "risk-capital" as a reliable criterion by pointing out that character loans by banks involved considerable risk but were hardly securities transactions.

47. *See* note 34 *supra* and accompanying text.

48. 544 F.2d at 1137.

49. *See* note 35 *supra* and accompanying text.

50. For cases involving claims of fraud by makers of promissory notes claimed to be

although the lending bank often can secure adequate disclosure from the borrower, the borrower rarely gets adequate information about the lender. The court also suggested that banks, even with their advantageous disclosure and bargaining positions, are inadequately protected against fraud by borrowers. Therefore the court concluded that all promissory notes purchased in the exercise of a bank's lending function should not be excluded from regulation as securities under the 1933 and 1934 Acts.[51]

Because the two foregoing modes of analyzing note transactions seemed unworkable, the instant court chose to adhere more closely to the description of security as including any note[52] and thus deemphasized the context clause. Accordingly, the instant court created a strong presumption that the context clause will have little bearing on which notes are securities by emphasizing the word "requires" in "unless the context otherwise requires." To effectuate its interpretation of the context clause, the court ruled that one who asserts that a short-term note is within or that a long-term note is not within the 1934 Act has the burden of showing that the context so requires.[53] The court enumerated situations in which the context of a long-term note transaction would satisfy defendant's burden of showing that the transaction was not regulated:

> the note delivered in consumer financing, the note secured by a mortgage,the short-term note secured by a lien on a business or some of its assets, the note evidencing a "character" loan to a bank customer, short-term notes secured by an assignment of accounts receivable, or a note which simply formalizes an open-account debt incurred in the ordinary course of business (particularly if, as in the case of the customer of a broker, it is collateralized).[54]

Only if a long-term promissory note bore a "close family resemblance"[55] to one of the six enumerated examples would it not be treated as a security under the 1934 Act. Because the instant notes did not resemble closely one of the six exceptions[56] the court held

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securities, see C.N.S. Enterprises, Inc. v. G. & G. Enterprises, Inc., 508 F.2d 1354 (7th Cir.), *cert. denied,* 423 U.S. 825 (1975); Lino v. City Inv. Co., 487 F.2d 689 (3d Cir. 1973); Movielab, Inc. v. Berkey Photo, Inc., 452 F.2d 662 (2d Cir. 1971).

51. 544 F.2d at 1137.

52. *See* note 11 *supra* and accompanying text.

53. The court also ruled that a party asserting that any note is not within the antifraud provisions of the 1933 Act has the burden of showing that the context requires that the note not be considered a "security." 544 F.2d at 1137-38; *see* notes 25 & 26 *supra* and accompanying text.

54. 544 F.2d at 1138.

55. *Id.*

56. For a description of the notes see note 3 *supra.*

that the notes were securities regulated under section 10(b) of the 1934 Act.[57]

Describing its analysis of note transactions as clearer and easier to apply than the "commercial-investment dichotomy" analysis of recent decisions in other circuits, the instant court nevertheless suggested that adoption of section 297(b)(3) of the Federal Securities Code[58] would be a more desirable solution. The court added that a grant of power to explicate the term "mercantile transaction" in section 297(b)(3) should be given to the SEC.[59]

## IV. COMMENT

The instant opinion, which discards the typical "commercial-investment dichotomy" analysis,[60] may be separated into two components. The first component is the presumption against operation of the context clause,[61] or, stated otherwise, a presumption that long-term notes are and short-term notes are not securities. By raising this presumption the court effectively preserves the short-term note exclusions,[62] which have been weakened considerably by recent decisions.[63] The exclusions, however, may have been overemphasized in the instant opinion. Numerous courts have found the scope of the 1934 Act's short-term note exclusion identical to the narrow scope of the 1933 Act's short-term note exemption.[64] The liberal application of the securities laws intended by its drafters further supports a narrow interpretation of the exclusionary provisions.[65] The instant court's presumption that long-term notes are securities does not conflict with the intent of the Acts, but presuming that short-term notes are not securities does appear to contradict legislative intent. Eliminating the presumption with respect to short-term

57. The portion of the court's opinion supporting note 53 *supra* suggests that the court also held that the notes were securities under § 17(a) of the 1933 Act as well as under the provisions of the 1934 Act. The instant court probably did not decide whether the notes were securities under the 1933 Act, however, because only § 10(b) of the 1934 Act was linked directly with the 6 note transactions spelled out by the court. 544 F.2d at 1138. Also, the instant court expressed some doubt as to whether a civil damages remedy existed under § 17(a). *Id.* at 1137-38 n.18. Possibly the court felt no need to rule on the § 17(a) claim because of its close resemblance to rule 10b-5 promulgated pursuant to § 10(b) of the 1934 Act.

58. *See* notes 39-40 *supra* and accompanying text.

59. Explication would be accomplished by rule in the same manner recommended in § 216A of the Federal Securities Code for the exemption of commercial paper. RD 1-3, § 216A.

60. *See* note 19 *supra* and accompanying text.

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

62. *See* text accompanying note 25 *supra.*

63. *See* notes 29-31 *supra* and accompanying text.

64. *See* notes 27 & 28 *supra* and accompanying text.

65. *See* note 14 *supra.*

notes would be pointless since the purpose of the court's presumption scheme, to revitalize the short-term note exclusions, is served effectively only when applied to short-term notes. In the future, therefore, courts should hesitate to presume notes are or are not securities because of length of time to maturity.[66]

The second component of the instant analysis is the enumeration of six examples of commercial note transactions that rebut the presumption of regulation as transactions involving securities under section 10(b) of the 1934 Act. Enumeration offers several advantages over the "commercial-investment dichotomy" analysis recently used in other circuits. Far more precise than balancing, the enumeration technique facilitates identification of notes that are securities: if a long-term note does not closely resemble one of the examples, it is a security. Furthermore, enumeration works well to restrict the scope of exclusions in statutes such as the 1934 Act, a remedial statute intended to have broad application. Nevertheless, exclusion by enumeration also has a major shortcoming—inflexibility. For example, new types of long-term note transactions may develop that conceptually are not securities but do not fall into one of the enumerated categories of note transactions excluded from regulation. Accordingly, the presumption that such notes are securities may result in regulation as securities in spite of their commercial nature.[67] Adding these new types of long-term note transactions to the list of unregulated commercial transactions would solve the problem, assuming that the organization responsible for making such additions responds promptly to emergent types of commercial notes. The enumeration scheme, however, does not work well when applied to short-term note transactions. Under the presumption of the instant analysis that short-term notes would not be securities "unless the context otherwise requires,"[68] all short-term notes that clearly are securities would have to be enumerated. Because of the varied assortment of securities, even enumerating the short-term note transactions that clearly are securities would be infeasible.[69]

An alternative to the instant decision would be to hold that all

66. The proposed Federal Securities Code has taken this position with respect to its antifraud provisions. *See* note 41 *supra.*

67. Some commentators have felt the inflexibility of enumeration mandated the adoption of the more common "dichotomy" analysis, which avoids inflexibility by balancing the relevant facts of the transaction. *See* Coffey, *supra* note 24, at 369-70; Long, *supra* note 16, at 100.

68. *See* note 53 *supra* and accompanying text.

69. It is this impossibility of enumerating all securities transactions that prompted Professor Coffey to suggest the use of conceptual criteria by the courts. *See* Coffey, *supra* note 24 *passim*; Long, *supra* note 16, at 100.

notes are presumed to be securities unless within one of the enumerated examples of commercial note transactions. Thus the precision attributable to enumeration under the instant analysis would be preserved, and the application of the securities laws to promissory notes would be broadened. By eliminating the need to enumerate short-term note transactions in which securities are involved, the major drawback of enumeration would be avoided. Although the short-term note exclusions under the 1933 and 1934 Acts would not operate to distinguish notes maturing in nine months or less from notes with longer maturities, the probable intent of Congress—to exclude high-quality commercial paper[70] from regulation—would be preserved. Furthermore, presuming that notes of all maturities are securities comports with the approach taken by the Federal Securities Code[71] as well as recent decisions made under existing securities law.[72]

The instant court appropriately suggests adoption of the exclusion in section 297(b)(3) of the Federal Securities Code for notes created in "mercantile transactions," a term that better articulates the present application of the context clause to notes. More importantly, the instant opinion recommends that Congress empower the SEC to explicate by rule "mercantile transaction." If the SEC were empowered to enumerate[73] categories of notes created in mercantile transactions, the difficult question of whether a note is a security could be clarified by a single, authoritative source. The examples set forth in the instant opinion might provide a foundation for the SEC rule, which could be expanded as appropriate to include new types of mercantile transactions.

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70. *See* note 27 *supra.*

71. *See* notes 41-43 *supra* and accompanying text.

72. *See* notes 29-31 *supra* and accompanying text.

73. Use of conceptual criteria rather than enumerated examples by the SEC to define "mercantile transaction" probably would pose interpretive problems like those faced under the "commercial-investment dichotomy" analysis. *See* notes 51-52 *supra* and accompanying text.

# Securities Law—Securities Fraud—Proof of Causation in 10b-5 Nondisclosure Cases Involving Trading on Impersonal Markets

## I. FACTS AND HOLDING

Plaintiffs[1] brought an action under section 10(b) of the Securities and Exchange Act of 1934[2] and rule 10b-5[3] promulgated thereunder for damages suffered from the sale of stock interests in Old Line Life Insurance Company (Old Line)[4] during a period in which Old Line was negotiating a merger.[5] During the negotiations, but two months prior to plaintiffs' sales, defendants purchased Old Line[6] stock allegedly on the basis of undisclosed insider information[7] concerning the merger, in violation of the rule 10b-5 "disclose or abstain" standard[8] for insiders trading in the open market.[9] Plain-

1. Plaintiffs are 5 individual investors who purchased a total of 13,818 shares of Old Line stock. Two of the plaintiffs bought stock in May 1972. The other plaintiffs purchased their stock in 1967.

2. Section 10(b) of the Securities Excbange Act of 1934 [hereinafter cited as the 1934 Act], 15 U.S.C. § 78(j) (1970), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

3. 17 C.F.R. § 240.10b-5 (1976) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [sic] commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. Plaintiffs sold their stock in June 1972.

5. U.S. Life Corporation (USLIFE) and Old Line began commercial negotiations for merger on April 19, 1972. The merger first was announced publicly on June 29, 1972.

6. Defendants purchased 8,625 shares of Old Line stock during the period April 21-27, 1972.

7. The chairman of USLIFE contacted defendant James C. Bradford (Bradford) concerning the possible acquisition of Old Line by USLIFE; Bradford served as intermediary between the negotiating parties.

8. *See* text accompanying notes 15-16 *infra.*

9. The SEC filed a rule 10b-5 enforcement action against defendants which was termi-

tiffs contended that insiders who trade in an impersonal market on the basis of material inside information, without first disclosing such information, are liable to investors who suffer loss in the impersonal market by selling without knowledge of the material information, even though the insiders do not purchase the shares sold by plaintiff sellers. Defendants argued that they could not be liable to plaintiffs because defendant's purchases had no causal relationship with plaintiffs' losses.[10] The district court held defendants liable for trading on the basis of material inside information without first disclosing that information.[11] On appeal to the United States Court of Appeals for the Sixth Circuit, *held,* reversed and remanded. An insider who trades in an impersonal market on the basis of undisclosed material information in violation of rule 10b-5 is not liable to an investor who trades in an impersonal market unaware of the material information and otherwise unaffected by the wrongful acts of the insider, because there is no causal connection between the insider's wrongdoing and the investor's loss. *Fridrich v. Bradford,* [Current] FED. SEC. L. REP. (CCH) ¶ 95,723 (6th Cir. Sept. 15, 1976), *cert. denied,* 45 U.S.L.W. 3460 (1976).

## II. LEGAL BACKGROUND

Although section 10(b) of the 1934 Act[12] and rule 10b-5[13] do not expressly provide a civil remedy for their violation, courts have implied a remedy and have used the common law tort of deceit to provide the elements of the cause of action.[14] The standard of con-

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nated by the filing of a stipulation of settlement and the entry of a consent judgment permanently enjoining defendants from violating § 10(b) in connection with Old Line securities and ordering the creation of a fund to disperse payments to persons who filed claims under the terms of the consent judgment. Those entitled to file claims were defined by the judgment as: (a) any person other than a customer of J.C. Bradford and Co. who sold any shares of Old Line to J.C. Bradford and Co. in the period from April 21, 1972, to April 27, 1972, and (b) any customer of Bradford and Co. who sold any shares of Old Line to Bradford and Co. in the period of April 21, 1972, to June 29, 1972. Fridrich v. Bradford, [Current] FED. SEC. L. REP. (CCH) ¶ 95,723, at 90,518 (6th Cir. Sept. 15, 1976).

10. Defendants also argued in their brief that insiders owe a duty to disclose only to persons with whom they deal, and that since defendants did not deal with plaintiffs, no duty was breached. Brief for Appellants at 13, Fridrich v. Bradford, [Current] FED. SEC. L. REP. (CCH) ¶ 95,723 (6th Cir. Sept. 15, 1976).

11. The District Court for the Middle District of Tennessee entered judgment in the aggregate amount of $361,186.75. The district court also found that defendants had violated rule 10b-6 by virtue of their continuous trading activity in Old Line stock from April through November 1972, the period in which the terms of the merger were being established. The instant court reversed the finding of liability under rule 10b-6 by applying its causation test. [Current] FED. SEC. L. REP. (CCH) ¶ 95,723, at 90,519, 90,528.

12. 15 U.S.C. § 78(j) (1970).

13. 17 C.F.R. § 240.10b-5 (1976).

14. This remedy was first implied in Kardon v. National Gypsum Co., 69 F. Supp. 512

duct in civil cases involving nondisclosure of material inside information is the "disclose or abstain" rule developed in *SEC v. Texas Gulf Sulphur Co.*,[15] an SEC enforcement action charging Texas Gulf Sulphur (TGS) and thirteen individuals with purchasing TGS stock and calls on the strength of inside information of favorable exploratory drilling results. In order to insure that all investors trading on impersonal markets have relatively equal access to material information, the *TGS* court held that anyone possessing material inside information must either disclose it to the investing public or abstain from trading in or recommending the subject security.[16]

Proof of a causal connection between defendant's wrongdoing and plaintiff's loss seemed to be a "rock-bottom limiting factor" in early attempts to impose civil liability in nondisclosure cases.[17] In *Joseph v. Farnsworth Radio & Television Corp.*,[18] a stockholders' derivative action for misstatements and omissions of material facts in connection with the sale of stock, the court held that a "semblance of privity" between the vendor and purchaser is requisite to such an action.[19] The *Farnsworth* court found such requisite causal relationship lacking and granted a defense motion to dismiss for failure to state a claim upon which relief could be granted.[20] *Reynolds v. Texas Gulf Sulphur*[21] is a more recent judicial recognition of the causation requirement in private rule 10b-5 actions based on nondisclosure.[22] In *Reynolds*, plaintiff sought damages for profits

(E.D. Pa. 1946). *See also* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

15. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

16. *Id.* at 848.

17. Bromberg, *Are There Limits to Rule 10b-5?*, 29 BUS. LAW. 167, 173 (1974). This connection requirement has been stated in terms of "causation" and "reliance." *See* Shapiro v. Merill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 239 (2d Cir. 1974).

18. 99 F. Supp. 701 (S.D.N.Y. 1951), *aff'd*, 198 F.2d 883 (2d Cir. 1952).

19. *Id.* at 706. The court cited Fischman v. Raytheon Mfg. Co., 188 F.2d 783 (2d Cir. 1951), as an example of what it meant by "semblance of privity:"

> The common stockholders should be permitted to amend . . . by alleging facts showing that the defendants deliberately used the prospectus of registration statement for the purpose of fraudulently inducing the purchase of common stock sold by the defendants and that, in this fraudulent purpose, the defendants were successful *vis a vis* the common stockholders here.

99 F. Supp. at 706. The requirement of formal privity has heen discredited because of the impersonal nature of markets. *See* Mitchell v. Texas Gulf Sulphur, 446 F.2d 90, 101 (10th Cir. 1971). *See generally* Ruder, *Texas Gulf Sulphur — The Second Round: Privity and State of Mind in Rule 10b-5 Purchase and Sale Cases*, 63 NW. U.L. REV. 423, 435-44 (1968).

20. 99 F. Supp. at 706-07.

21. 309 F. Supp. 548 (D. Utah 1970), *aff'd as modified*, 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971), 405 U.S. 918 (1972).

22. *Reynolds* is a private 10b-5 action arising from the same transactions challenged by the SEC in *SEC v. Texas Gulf Sulphur*. *See* note 15 *supra* & accompanying text.

he claimed to have lost on stock he sold during a period in which defendants were trading on inside information. The *Reynolds* court held it necessary for plaintiff to prove "some causative effect"[23] between defendants' wrongdoing and plaintiffs' damages in order to recover. The court also held that such causation does not follow from a finding in an earlier action brought by the SEC[24] that defendants had violated section 10(b) and rule 10b-5 by purchasing stock without first publicly disclosing the inside information they possessed.[25]

The Supreme Court in *Affiliated Ute Citizens v. United States*[26] eased the strict requirement of proof of causation in nondisclosure cases. In *Affiliated Ute*, terminated Ute Indians[27] created the Ute Distribution Corporation (UDC)[28] to manage the assets[29] of the tribe as part of a plan for distributing the assets to individual terminated Utes. UDC issued ten shares of its stock to each terminated Ute and agreed that First Security Bank of Utah would be its transfer agent. First Security and some of its employees purchased stock from a group of the terminated Utes without disclosing the higher price at which the securities were being traded in a secondary market developed by the bank.[30] There was no positive proof that the terminated Utes had relied on the fraud of the defendants in deciding to sell their stock. The Court concluded:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . . The obligation to disclose and this withholding of a material fact establish the the requisite element of causation in fact.[31]

Since *Affiliated Ute*, the lower courts have, with one exception,[32] adopted a presumption in nondisclosure cases that causation

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23. The court pointed out that "some causative effect" does not require the establishment of privity of contract, but did not define exactly what the term does mean. The court did conclude that materiality is not the test. 309 F. Supp. at 558-59.

24. *See* note 15 *supra* & accompanying text.

25. 309 F. Supp. at 558.

26. 406 U.S. 128 (1972).

27. The designation "terminated Ute" is used in this Comment in place of the statutory term "mixed-blood." *See id.* at 133 n.3.

28. The UDC was authorized by The Ute Indian Termination Act, 25 U.S.C. §§ 677-77aa (1970).

29. The assets consisted of oil, gas, and mineral rights and unadjudicated or unliquidated claims against the Government. 406 U.S. at 135.

30. *Id.* at 144-49.

31. *Id.* at 153-54.

32. The exception is Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir.) (en banc) (per curiam) (alternative holding), *cert. denied*, 414 U.S. 874 (1973).

in fact is established if the undisclosed information is material, rather than requiring plaintiff to present positive proof of reliance.[33] The impossibility of proving reliance in such cases has been given as the rationale for the policy.[34] In *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith,*[35] plaintiffs, purchasers of common stock of Douglas Corporation, alleged that defendants, underwriters of a Douglas debenture issue, had divulged inside information concerning revised downward earnings projections to certain of their institutional investors without disclosing the inside information to the public.[36] The district court,[37] in denying a defense motion for judgment on the pleadings, held that the act of trading without disclosing material inside information caused the injury to plaintiffs.[38] The Second Circuit further concluded that the "causation in fact" holding of *Affiliated Ute* precluded any arguments defendants might make that no causal connection existed between their conduct and plaintiffs' damage,[39] even though *Shapiro* did not involve a face-to-face transaction as did *Affiliated Ute.*[40] Additionally, the Second Circuit recognized that the resulting judgment for damages might be so substantial that they may constitute a "Draconian liability" to defendants, but left the issue of proper measure of damages to be

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*Financial Industrial Fund* involved the same transactions as Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228 (2d Cir. 1974), but the court held, without mentioning *Affiliated Ute,* that plaintiff had the burden of demonstrating reliance on the acts or inaction of the defendant in order to prove causation.

33. *See, e.g.,* Blackie v. Barrack, 524 F.2d 891 (9th Cir. 1975); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974); Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1973); Reeder v. Mastercraft Elec. Corp., 363 F. Supp. 574 (S.D.N.Y. 1973); Taylor v. Smith, Barney & Co., 358 F. Supp. 892 (D. Utah 1973). *See generally* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5,* 88 HARV. L. REV. 584, 590-91 (1975).

34. Titan Group, Inc. v. Faggen, 513 F.2d 234, 239 (2d Cir.), *cert. denied,* 423 U.S. 840 (1975). In cases involving affirmative misrepresentations, it can be demonstrated that the injured party relied upon the affirmative statements of the defendant; in nondisclosure cases, however, it is impossible to demonstrate reliance since there is nothing affirmative upon which the injured party could rely. *Id.; see* 2 A. BROMBERG, SECURITIES LAW—FRAUD: SEC RULE 10b-5 § 8.7(2), at 220 (1975) [hereinafter cited as BROMBERG].

35. 353 F. Supp. 264 (S.D.N.Y. 1972), *aff'd,* 495 F.2d 228 (2d Cir. 1974).

36. Plaintiffs purchased stock during the same period of time that defendants divulged the inside information to their selected investors. These institutions sold more than 165,000 shares of Douglas common stock during that period. 495 F.2d at 232.

37. District Judge Tenney wrote an extensive opinion on which the circuit court relied heavily. 353 F. Supp. 264 (S.D.N.Y. 1972).

38. *Id.* at 278.

39. 495 F.2d at 238.

40. In Rochez Bros. v. Rhoades, 491 F.2d 402 (3d Cir. 1974), the Third Circuit also presumed reliance to prove causation, but took the position that the defendant should be allowed to rebut this presumption if he can establish that plaintiff would have acted in the same manner had he known the undisclosed information. *Id.* at 410.

determined at an evidentiary hearing in the district court.[41] The instant case gave the Sixth Circuit the opportunity to address the potentially unlimited liability of an insider who trades in an impersonal market on the basis of undisclosed material information and to determine the extent of the applicability of rule 10b-5 in private causes of action based on such trading.

## III. THE INSTANT OPINION

The instant court[42] rejected the trend toward presumption of reliance to prove causation and adopted the traditional requirement of *Farnsworth* and *Reynolds* that plaintiffs must prove that defendants' acts were causally connected with any loss claimed by plaintiffs.[43] In rejecting *Shapiro,* the court determined that the act of trading by insiders, not the failure to disclose, constituted the violation of rule 10b-5, since it was the act of trading that resulted in the illicit profits. The court observed that an insider's duty to disclose is not absolute, but alternative. If the insider does not trade he has the absolute right to keep certain material information secret, and investors must accept the risk of trading in an open market unaware of some undisclosed material information. Thus although the court recognized that defendants' trading on the basis of material undisclosed information impaired the integrity of the market and violated the rule, their trading did not alter plaintiffs' expectations when they sold their stock, and in no way influenced plaintiffs' trading decisions. In reaching this decision, the court interpreted *Affiliated Ute* more narrowly than did the *Shapiro* court and distinguished it on the ground that the defendants there had perpetrated a scheme to induce plaintiffs to sell their stock, whereas in the instant case the defendants had no relationship with the plaintiffs. The court acknowledged that rule 10b-5 should encompass open market transactions, but rejected the view that civil remedies in rule 10b-5 actions should be coextensive in their reach to those of the SEC when the application of such a view would lead to an unjust result. The

41. The court concluded that since the case came to it on an appeal of an interlocutory order denying defendants' motion for judgment on the pleadings, the issue of relief was not before it. Also, given the potential liability at stake, the court felt that an evidentiary hearing should be held. 495 F.2d at 241-42.

The potential liability for the insiders in *Shapiro,* in excess of the profit on their transactions, was approximately $9 million. Note, *Damages to Uninformed Traders for Insider Trading on Impersonal Exchanges,* 74 COLUM. L. REV. 299, 308 n.83 (1974).

42. Judge Engel delivered the opinion of the court in which Judge Peck concurred; Judge Celebreeze filed a separate concurring opinion.

43. [Current] FED. SEC. L. REP. (CCH) ¶ 95,723, at 90,524.

court found that extension of civil liability would result in two unfavorable consequences: (1) creation of a windfall to those investors aware of their nebulous rights; and (2) imposition of potentially unlimited "punitive" damages. Thus the court refused to extend the private remedy by holding that no causal connection exists in a nondisclosure case involving insiders trading on the impersonal market in which plaintiffs neither dealt with the insiders nor were otherwise influenced by the wrongful acts of the insiders.

The concurring opinion of Judge Celebrezze[44] emphasized the need to impose a rational limitation on the scope of civil liability under rule 10b-5 for insiders trading in the open market. He interpreted the majority opinion to hold that persons who trade on an open market weeks after the insider has concluded his trading activity must establish more than the materiality of the undisclosed information to demonstrate that their losses were caused by the insiders' trading. Determining that the date the insiders cease trading rather than the date the information is finally disclosed should be the focus in cutting off liability,[45] Judge Celebreeze concluded that recovery should be limited to those investors who traded during the period when insiders were trading in or recommending trading in the stock.

## IV. COMMENT

With this decision, the Sixth Circuit has expressed its unwillingness to extend to nondisclosure cases in which there is no relationship between plaintiffs and insiders the presumption that causation in fact is established if the nondisclosure is material. In so doing, the court adopted the most restrictive position regarding recovery in private civil actions brought under rule 10b-5.[46] Since proof of causation in nondisclosure cases involving impersonal markets is almost impossible,[47] this position virtually eliminates recoveries by investors against insiders in private 10b-5 actions. This result is supportable by the argument made by the instant court that the investors were not injured by the insiders' acts and thus not entitled to recovery since the investors would have traded whether

44. *Id.* at 90,528-32.

45. Judge Celebrezze based the conclusion on the theory that only when the insider enters the market and creates an informational imbalance does the insider have a duty to disclose. Wben the insider ceases trading, the informational imbalance ends and the market returns to its normal state. *Id.* at 90,530-31.

46. *See generally* 2 BROMBERG, *supra* note 34, at § 8.7(2), at 220; Note, note 41 *supra.*

47. *See* note 34 *supra.*

or not the insiders were in the market. The criticism that the position immunizes from liability insiders who trade on national exchanges or over the counter in violation of rule 10b-5 outweighs the supporting argument, however, and renders this solution to the liability problem unacceptable. In contrast, the *Shapiro* decision implies a full recovery to all investors who traded during the period in which the insider violated rule 10b-5.[48] This position finds support in the argument that the purpose of rule 10b-5 is to insure investors who trade on impersonal markets that they have equal access to material information and to protect them in the event that insiders trade on the basis of nondisclosed information.[49] The existence of potentially unlimited liability of insiders as a result of this position, however, eliminates it as a satisfactory answer to the liability question. Such unlimited liability could have catastrophic effects on corporations, officers, directors, employees, and tippees who assume insider status,[50] and infers a punitive connotation to the damages in contradiction to the remedial intent of the statute.[51]

The harshness of the two extremes represented by the instant opinion and *Shapiro* suggests that a compromise setting rational limits on civil liability in private nondisclosure cases is preferable. Judge Celebreeze's concurring opinion suggests one such compromise.[52] His approach is appealing in that it restricts the liability of insiders to the period of time during which the informational imbalance existed as a result of the insider trading.[53] This approach, however, leaves open the possibility of catastrophic liability to insiders[54] and therefore is not a satisfactory solution to the liability question. Another compromise approach that has been discussed is

48. *See* note 41 *supra* & accompanying text.

49. SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

50. An example of such catastrophic effects was the potential liability of Texas Gulf Sulphur from private suits arising from the activities discussed in text accompanying note 15 *supra*. Those damages could have been equal to $130 per share for every share traded during the period of violation. Since approximately 3 million shares were traded during that period, damages could have amounted to over $390 million. This figure was approximately $150 million more than the net worth of TGS at that time. Ruder, note 19 *supra*, at 429.

51. *See* 3 BROMBERG, *supra* note 34, at § 9.1, at 229 (1975).

52. *See* text accompanying notes 44-45 *supra*.

53. *See* note 45 *supra*.

54. If the subject security is actively traded, even a mild fluctuation in price over a short period of time could result in enormous potential liability to insiders. For example, over a specific 4-day period, United Airlines common stock had a trading volume of 5,155,000 shares, and increased in value over $2.35 per share. Wall Street J., Nov. 16, 1976, at 45, col 4; Nov. 17, 1976, at 45, col. 3; Nov. 18, 1976, at 45, col. 3; Nov. 19, 1976, at 45, col. 2. Therefore, potential liability in a 10b-5 private action could be over $12 million for a 4-day period.

the limitation of recovery to investors in privity with the insiders.[55] Although this approach solves the problem of proof of causation and effectively limits potential liability, the lack of meaning of the term privity in impersonal market trading strikes a fatal blow to the concept. Additionally, even if privity could be effectively defined in the impersonal market context, the administrative problems of tracing specific shares of stock would render this approach unworkable.

The most persuasive compromise approach to the liability question is that suggested by the proposed Federal Securities Code, which limits the insiders' damages to the profits realized from their illegal trading.[56] This approach has several advantages. First, it does not insulate from liability insiders who trade illegally, as does the instant opinion. If the nondisclosure is material, causation is established and liability is imposed on the insider. Second, the liability is rationally limited and the potential catastrophic results of *Shapiro* are avoided. Finally, because the insiders' illicit profits represent the net effect on the market of the insiders' illegal trading, since beyond these illicit profits all losses suffered by uninformed investors result in offsetting gains to other investors, the market balance is restored by retrieving the insiders' illegal profits, even though individual investors might suffer. The major disadvantages of this approach, in addition to the possible losses of some individual investors, are the administrative problems of determination of the injured parties and distribution of pro rata shares of the recovery to them. As an alternative, the illicit profits could be channelled back into the corporation whose stock was illegally traded if the corporation itself did not violate rule 10b-5.[57] On balance, this approach of the proposed Federal Securities Code to liability of insiders is preferable to the alternatives and should be adopted to prevent the potential harshness to insiders of *Shapiro* and the harshness to investors of the instant opinion.

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55. Note, note 41 *supra*, at 311-13.

56. ALI FED. SEC. CODE § 1402(f)(2)(B) (Tent. Draft No. 2, 1973) provides:

. . .

(2) For purposes of section 1402(b), the measure of damages as defined in paragraph (1) is

. . .

(B) limited (after application of clause (A)) to the extent of the securities that the defendant sold or bought.

57. *See* 2 BROMBERG, *supra* note 34, at § 8.7(2), at 218.