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Recent Cases

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RECENT CASES

Civil Procedure — Appellate Jurisdiction — Orders Denying Disqualification of Counsel on Ethical Grounds Are Not Final Decisions Subject to Immediate Review Under 28 U.S.C. § 1291

I. Facts and Holding

Petitioner,[1] an applicant for a Federal Communications Commission (FCC) broadcasting license,[2] sought interlocutory review of a Commission order[3] denying a motion to disqualify the law firm that had represented competitor RKO for thirty years. Petitioner alleged that participation by the firm, which included an attorney who was chairman of the FCC while RKO's application was under consideration,[4] constituted a violation of Canons Five[5] and Nine[6] of the ABA Code of Professional Responsibility. The FCC denied the motion to disqualify, finding that the firm had taken sufficient precautionary measures[7] to prevent an ethical violation.[8]

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1. Petitioner was Community Broadcasting of Boston, Inc.

2. Community Broadcasting and the Dudley Station Corp. filed competing applications for the broadcasting license that RKO General; Inc., was seeking to renew.

3. RKO General, Inc., 59 F.C.C.2d 641 (1976), 37 Rad. Reg. 2d (P&F) 461 (1976).

4. RKO's application for renewal had been under consideration since December 31, 1968. Dean Burch, the attorney in question, was employed by the FCC from October 1969 until March 1974, and joined the firm in January 1975. Community Broadcasting of Boston, Inc. v. FCC, 546 F.2d 1022, 1024 (D.C. Cir. 1976).

5. Canon 5 of the ABA Code of Professional Responsibility provides: "A lawyer should exercise independent professional judgment on behalf of a client." Petitioner sought disqualification of the firm under Disciplinary Rule 5-105(D), which provides: "If a lawyer is required to decline employment or to withdraw from employment under a Disciplinary Rule, no partner, or associate, or any other lawyer affiliated with him or his firm, may accept or continue such employment."

6. Canon 9 of the ABA Code of Professional Responsibility provides: "A lawyer should avoid even the appearance of professional impropriety." To avoid the appearance of impropriety, Disciplinary Rule 9-101(B) requires that: "A lawyer shall not accept private employment in a matter in which he had substantial responsibility while he was a public employee."

7. In an effort to avoid confiicts of interest, the firm denied former government employees access to its files on matters for which they had responsibility while government employees, and other firm employees were forbidden to consult with the isolated member on the matter. Burch filed an affidavit attesting that he bad not shared any confidential FCC information with any member of the firm, and that he had no recollection of any information relating to RKO's application. Additionally, Burch's compensation was established so as to exclude any fees attributable to the case. RKO General, Inc., No. 18759, slip op. at 2 (FCC June 1, 1976), 37 Rad. Reg. 2d (P&F) at 462.

8. The FCC requested an advisory opinion from the ABA, which issued in response

Petitioner sought immediate review of the order as a final decision within the meaning of 28 U.S.C. § 1291.[9] Accepting respondent's contention that the order did not qualify under the final judgment rule,[10] the Court of Appeals for the District of Columbia Circuit *held*, appeal dismissed for lack of jurisdiction.[11] Interlocutory orders denying disqualification of counsel on ethical grounds are not final decisions subject to immediate review under 28 U.S.C. § 1291. *Community Broadcasting of Boston, Inc. v. FCC*, 546 F.2d 1022 (D.C. Cir. 1976).

II. LEGAL BACKGROUND

The comprehensive grant of jurisdiction to the courts of appeals conferred by 28 U.S.C. § 1291 includes the historic limitation that only final decisions can be appealed.[12] Designed to prevent piecemeal litigation and to conserve judicial resources, the final judgment rule operates to prohibit review of interlocutory orders until a decision on the merits has been rendered.[13] Since rigid adherence to

Professional Ethics Formal Opinion 342, 62 A.B.A.J. 517 (1976). The Opinion concluded that Disciplinary Rule 5-101(D) does not require disqualification of a firm if the former public employee is screened from direct or indirect participation in the case. *Id.* at 521.

9. Petitioner appealed under 28 U.S.C. § 2342(1) (1970), which provides in pertinent part: "The court of appeals has exclusive jurisdiction to . . . determine the validity of (1) all final orders of the Federal Communications Commission . . . ." The standard generally applied in determing whether an order meets the finality requirement of § 2342(1) is that the order "must impose an obligation, deny a right or fix some legal relationship as a consumation of the administrative process." Illinois Citizens Comm. for Broadcasting v. FCC, 515 F.2d 397, 402 (D.C. Cir. 1975).

In determining the appealability of the FCC order in question, however, the instant court focused on 28 U.S.C. § 1291 (1970), which provides:

> The courts of appeals shall have jurisdiction of appeals from all final decisions of the district courts of the United States. . . except where a direct review may be had in the Supreme Court.

Although the finality requirement of § 1291 usually is defined in terms of denying immediate review of any decision that is "tentative, informal or incomplete," courts have recognized that the policy considerations underlying the finality requirements of § 2342 and § 1291 are identical. *See, e.g.*, Howard Terminal v. United States, 239 F.2d 336, 337 (9th Cir. 1956) (discussing 5 U.S.C. § 1032 (1952), the predecessor to 28 U.S.C. § 2342).

10. Respondent FCC and intervenor RKO filed motions to dismiss the appeal for lack of jurisdiction.

11. The decision was a per curiam opinion by a panel consisting of Judges Wright, Tamm, and MacKinnon.

12. The final judgment rule has been a prerequisite to appeal since the Judiciary Act of 1789. Judiciary Act of 1789, ch. 20, § 22, 1 Stat. 84 (current version at 28 U.S.C. § 1291 (1970)). For an historical analysis of the final judgment rule, see Crick, *The Final Judgment as a Basis for Appeal*, 41 YALE L.J. 539 (1932).

13. The final judgment rule protects both litigants and the courts by eliminating unnecessary appeals and consequent delay, by removing the potential for harassment of litigants

the section 1291 requirement of finality can produce inequitable or inefficient results, however, judicial and statutory exceptions have been adopted to provide flexibility and to alleviate the harshness of the requirement. The three exceptions relevant to interlocutory review of orders denying disqualification of counsel are the collateral order doctrine announced in *Cohen v. Beneficial Industrial Loan Corp.*,[14] a writ of mandamus under the All Writs Act,[15] and discretionary appeal under 28 U.S.C. § 1292(b).[16]

In *Cohen v. Beneficial Industrial Loan Corp.*,[17] the Supreme Court announced the principal judicial exception to the final judgment rule. Noting that the requirement of finality should be given practical rather than technical effect, the Court recognized a small class of interlocutory orders that should be considered final for purposes of review. Under the collateral order doctrine developed by the Court, an interlocutory order will be considered a final decision subject to immediate review if: the order finally determines a claim of right "separable from, and collateral to" the rights asserted in the principal action; the claim of right is sufficiently important to warrant immediate review; and appeal after final judgment would be ineffective to prevent irreparable loss of the right.[18] Although allowing immediate review of the district court order in question as a final disposition of an important collateral right,[19] the Court qualified this exception to the final judgment rule by noting that the right at issue presented a "serious and unsettled question."[20] Fearing that

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through nuisance appeals, and by reducing the burden on the reviewing court's docket. American Express Warehousing, Ltd. v. Transamerica Ins. Co., 380 F.2d 277, 280 (2d Cir. 1967). Additionally, the rule "allows a consolidated review of all error and, under the normal scope of review doctrine, reduces the points of error which must be considered to those material to the result reached at trial." Note, *Interlocutory Appeals in the Federal Courts Under 28 U.S.C. § 1292(b)*, 88 HARV. L. REV. 607, 608-09 (1975) [hereinafter cited as *Interlocutory Appeals*]. *See* Note, *Appealability in the Federal Courts*, 75 HARV. L. REV. 351, 352 (1961) [hereinafter cited as *Federal Appealability*].

14. 337 U.S. 541 (1949). *See* notes 17-22 *infra* and accompanying text.

15. 28 U.S.C. § 1651 (1970). *See* notes 23-31 *infra* and accompanying text.

16. The Interlocutory Appeals Act of 1958, 28 U.S.C. § 1292(b) (1970). *See* notes 32-35 *infra* and accompanying text.

17. 337 U.S. 541 (1949).

18. *Id.* at 546.

19. In *Cohen*, defendant corporation appealed a district court order that a state statute requiring plaintiff shareholders to post security in derivative actions created a remedial rather than a substantive right and therefore was not applicable to a derivative action brought in federal court on diversity of citizenship. In affirming the Third Circuit's reversal of the district court order denying the corporate defendant's request for security, the Supreme Court discussed the appealability of the order.

20. The Court qualified its holding as follows:

But we do not mean that every order fixing security is subject to appeal. Here it is the

the *Cohen* doctrine would engulf the final judgment rule if applied to certain classes of orders, some courts have interpreted this caveat as limiting review to orders that present an issue arising in a wide spectrum of cases.[21] The Court, however, frequently has ignored the caveat to allow review of orders that decide only the merits of the particular case if the order threatens irreparable harm and appellate review would be ineffective in protecting or restoring the right at issue.[22]

The All Writs Act[23] provides the second exception to the final judgment rule. Issuance of a writ of mandamus under this statute traditionally has been appropriate only if a lower court has exceeded its power or abused its discretion.[24] The Supreme Court has empha-

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right to security that presents a serious and unsettled question. If the right were admitted or clear and the order involved only an exercise of discretion as to the amount of security, a matter the statute makes subject to reconsideration from time to time, appealability would present a different question.

337 U.S. at 547.

21. In Weight Watchers of Philadelphia, Inc. v. Weight Watchers Int'l, 455 F.2d 770 (2d Cir. 1972), the court held that an order allowing plaintiff to contact other members of a potential class did not involve a serious and unsettled question, noting that:

> [an] important factor bearing on the application of the *Cohen* doctrine . . . is whether a decision will settle a point once and for all, . . . or will open the way for a flood of appeals concerning the propriety of a district court's ruling on the facts of the particular suit.

Id. at 773; *accord,* Donlon Indus. v. Forte, 402 F.2d 935 (2d Cir. 1968) (orders denying a request for the posting of security do not meet the serious and unsettled question requirement). Discovery orders also generally have been held not to present a serious and unsettled question. *See, e.g.*, IBM v. United States, 480 F.2d 293 (2d Cir. 1973); American Express Warehousing, Ltd. v. Transamerica Ins. Co., 380 F.2d 277 (2d Cir. 1967).

22. One year after *Cohen,* in Swift & Co. Packers v. Compania Colombiana Del Caribe, 339 U.S. 684 (1950), the Court relied on the collateral order doctrine to restore the attachment of a foreign vessel. Although the jurisdiction of the district court to examine a transaction between two foreign corporations was at issue, the Court predicated its decision on the potential for irreparable harm and the empty rite that review of the order would provide after final judgment. *See, e.g.*, Stack v. Boyle, 342 U.S. 1 (1951) (appeal allowed from order refusing to reduce bail); Roberts v. United States Dist. Ct., 339 U.S. 844 (1950) (appeal allowed from an order refusing plaintiff leave to proceed in forma pauperis). The courts that have allowed appeal from orders denying disqualification of counsel under *Cohen* have not mentioned the "serious and unsettled question" caveat, but have relied instead on the court's statement that the final judgment rule should be given "practical rather than technical construction."

23. The All Writs Act, 28 U.S.C. § 1651 (1970), provides in pertinent part:

> (a) The Supreme Court and all courts established by Act of Congress may issue all writs necessary or appropriate in aid of their respective jurisdictions and agreeable to the usages and principles of law.

See generally 9 MOORE'S FEDERAL PRACTICE ¶ 110.26-.28 to 275-316 (2d ed. 1975) [hereinafter cited as MOORE].

24. The writ traditionally has been used only "to confine an inferior court to a lawful exercise of its prescribed jurisdiction or to compel it to exercise its authority when it is its duty to do so." Roche v. Evaporated Milk Ass'n, 319 U.S. 21, 26 (1943). Additionally, the

sized the drastic nature of the remedy, noting that mandamus should not be issued to thwart the policy against piecemeal litigation or to provide review of nonappealable orders except in extraordinary cases.[25] Thus, as noted by the Fourth Circuit,[26] orders relating to disqualification of counsel, traditionally matters within the discretion of the trial court,[27] are not subject to mandamus in the absence of an abuse of discretion or extradordinary circumstances. In spite of these restrictions on the use of mandamus, the Ninth Circuit in *Cord v. Smith*[28] granted the writ as a substitute for appeal under section 1291. Although the court held that the final judgment rule prohibits review of orders denying disqualification of counsel, it nevertheless granted mandamus to avoid the potential for irreparable harm.[29] Since the court relied on a Second Circuit decision that subsequently has been overruled,[30] however, continued adherence to this approach is questionable.[31]

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party requesting mandamus has the burden of proving that the "right to issuance of the writ is 'clear and indisputable.'" Bankers Life & Cas. Co. v. Holland, 346 U.S. 379, 384 (1953).

25. In Will v. United States, 389 U.S. 90, 104 (1967), the Court stressed the limited availability of the writ and noted that it is not available to review a court's erroneous ruling on a matter within its jurisdiction:

> Courts faced with petitions for the peremptory writs must be careful lest they suffer themselves to be misled by labels such as "abuse of discretion" and "want of power" into interlocutory review of nonappealable orders on the mere ground that they may be erroneous.

Id. at 98 n.6; *accord*, Donnelly v. Parker, 486 F.2d 402 (D.C. Cir. 1973).

26. United States v. Hankish, 462 F.2d 316 (4th Cir. 1972) (order granting disqualification).

27. Appellate review of disqualification rulings made pursuant to the supervisory authority of the trial court traditionally bas been limited to finding an abuse of discretion. The Third and Fifth Circuits, however, have determined that such orders involve purely legal questions in which the "District Courts have no functional advantage over appellate courts in their formulation and application of ethical norms." Woods v. Covington County Bank, 537 F.2d 804, 810 (5th Cir. 1976). These circuits now apply the clearly erroneous rule to orders granting or denying disqualification. *Id.*; American Roller Co. v. Budinger, 513 F.2d 982, 985 n.3 (3d Cir. 1975). *See* note 34 *infra*.

28. 338 F.2d 516 (9th Cir. 1964), *clarified*, 370 F.2d 418 (9th Cir. 1966).

29. In *Cord*, the court denied appeal under § 1291, but directed the trial court to disqualify tbe attorney by writ of mandamus. The court noted that the continued participation of an attorney who should be disqualified for a conflict of interest would "bring about the very evil which the rule against his participation is designed to prevent, and a subsequent reversal based upon such participation cannot undo the damage that will have been done as a result of such participation." 338 F.2d at 521-22.

30. The *Cord* court relied on Fleischer v. Phillips, 264 F.2d 515 (2d. Cir.), *cert. denied*, 359 U.S. 1002 (1959), in determining that orders denying disqualification of counsel are not appealable under the *Cohen* exception to the final judgment rule. In Silver Chrysler Plymouth, Inc. v. Chrysler Motors Corp., 496 F.2d 800 (2d Cir. 1974), the Second Circuit overruled *Fleischer* and held that such orders are subject to immediate review under the *Cohen* doctrine. *See* notes 47-50 *infra* and accompanying text.

31. The Ninth Circuit bas not bad an opportunity to reconsider its treatment of orders denying disqualification of counsel since *Silver Chrysler* overruled *Fleischer*.

The third exception to the requirement of finality, 28 U.S.C. § 1292(b),[32] authorizes discretionary appeal if the district court certifies that the order involves a controlling question of law subject to substantial grounds for difference of opinion, and that an immediate appeal would materially advance the ultimate termination of the litigation. Although this statute makes every interlocutory order potentially subject to immediate review, courts have adopted different standards for determining whether an order presents a controlling[33] question of law.[34] A majority of the circuits considering the

32. 28 U.S.C. § 1292(b) (1970) provides in pertinent part:

(b) When a district judge, in making in a civil action an order not otherwise appealable under tbis section, sball be of the opinion that such order involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from tbe order may materially advance the ultimate termination of the litigation, he shall so state in writing in sucb order. The Court of Appeals may thereupon, in its discretion, permit an appeal to be taken from such order, if application is made to it within ten days after entry of the order . . . .

See generally 9 MOORE, *supra* note 23, at ¶ 110.22; Note, *Section 1292(b): Eight Years of Undefined Discretion,* 54 GEO. L.J. 940 (1966);*Interlocutory Appeals, supra* note 13; *Federal Appealability, supra* note 13; Note, *Discretionary Appeals of District Court Interlocutory Orders: A Guided Tour Through Section 1292(b) of the Judicial Code,* 69 YALE L.J. 333 (1959).

28 U.S.C. § 1292(a) (1970) authorizes appeal from injunctive orders. This section, however, has been interpreted as applying only "to injunctions which give or aid in giving some or all of the substantive relief sought by a complaint . . . and not as including restraints or directions in orders concerning the conduct of the parties or their counsel, unrelated to the substantive issues in the action . . . ." International Prods. Corp. v. Koons, 325 F.2d 403, 406 (2d Cir. 1963). Althougb motions requesting disqualification of counsel sometimes are phrased as requests for injunctions, it has heen held that "the mere presence of words of restraint or direction in an order" does not make § 1292(a) applicable. *Id.* Thus, review of orders denying disqualification under § 1292(a) has been rejected in Cord v. Smith, 338 F.2d 516 (9th Cir. 1964), *clarified,* 370 F.2d 418 (9th Cir. 1966), and in Fleischer v. Phillips, 264 F.2d 515 (2d Cir.), *cert. denied,* 359 U.S. 1002 (1959).

33. Professor Moore states that an order dispositive of the case clearly is controlling, and maintains that the requirement of a controlling question should be equated with the potential for substantially accelerating the termination of the litigation. 9 MOORE, *supra* note 23, ¶ 110.22, at 260. *See also Interlocutory Appeals, supra* note 13, at 618. Courts, however, have applied tbe following standards in determining whether an order presents a controlling question: Katz v. Carte Blanche Corp., 496 F.2d 747 (3rd Cir. 1974), *cert. denied,* 419 U.S. 885 (1975) (must at least be an order which, if erroneous, would he reversible error); United States v. Woodbury, 263 F.2d 784, 787 (9th Cir. 1959) (to be controlling, a question need not be dispositive of the litigation); Kohn v. Royall, Koegel & Wells, 59 F.R.D. 515, 525 (S.D.N.Y. 1973), *appeal dismissed,* 496 F.2d 1094 (2d Cir. 1974) ("a question is deemed controlling only if it may contribute to the determination . . . of a wide spectrum of cases."); Joe Grasso & Son, Inc., v. United States, 42 F.R.D. 329, 334 (S.D. Tex. 1966), *aff'd,* 380 F.2d 749 (5th Cir. 1967) (if appeal from an order would eliminate the possibility of an abortive trial or facilitate settlement, it should be considered controlling).

34. Professor Moore states that questions involving conflicts of interest are almost invariably questions of fact. 9 MOORE, *supra* note 23, ¶ 110.13 [10] at 190. Since § 1292(b) requires a controlling question of "law," however, courts bave denied review under § 1292(b) of matters within the discretion of the trial court that involve mixed questions of law and fact. This result has been criticized for not allowing limited review to determine if the trial

application of section 1292(b) to orders denying disqualification of counsel have held that such orders do not meet the requirements of the statute.[35]

Orders granting or denying disqualification of counsel present several competing interests. The litigant's right to counsel of his choice[36] may conflict with the need for public confidence in the profession[37] and with the opposing litigant's right to a trial free from the risk of disclosure by an attorney possessing adverse confidential information.[38] Since post-judgment appeal of orders affecting these

court considered the proper factors. *Interlocutory Appeals, supra* note 13 at 618 n.57. The Third and Fifth Circuits, however, have re-examined the characterization of such orders as questions of fact, and concluded that they present questions of law. *See* Woods v. Covington County Bank, 537 F.2d 804, 810 (5th Cir. 1976); American Roller Co. v. Budinger, 513 F.2d 982, 985 n.3 (3d Cir. 1975); note 27 *supra*.

35. In Greene v. Singer Co., 509 F.2d 750 (3d Cir. 1971), the court declined to accept appeal of an order denying disqualification certified by the trial court under § 1292(b), but held the order appealable as a final decision under the *Cohen* doctrine. The Tenth Circuit in Waters v. Western Co. of N. America, 436 F.2d 1072 (10th Cir. 1971), dismissed an appeal under § 1292(b) as improvidently granted, stressing the trial court's discretion in such matters. Subsequently, however, the Tenth Circuit has held that such orders are appealable under *Cohen*. Fullmer v. Harper, 517 F.2d 20 (10th Cir. 1975). Although certifying an order granting disqualification in E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969), the court did not consider the availability of appeal under *Cohen*, noting that whether § 1291 confers appellate jurisdiction over such orders is a question to be determined by the court of appeals. *Id.* at 402. Since the appellate jurisdictions under §§ 1291 and 1292(b) are mutually exclusive, all the circuits that consider orders denying disqualification final decisions under the *Cohen* doctrine by implication reject the appealability of such orders under § 1292(b). For the circuits allowing appeal under *Cohen*, see notes 42-55 *infra* and accompanying text.

36. Several courts have construed the right to representation by counsel to mean the right to the attorney of one's choice. SEC v. Csapo, 533 F.2d 7 (D.C. Cir. 1976); Hull v. Celanese Corp., 513 F.2d 568 (2d Cir. 1975); Backer v. Commissioner, 275 F.2d 141 (5th Cir. 1960). In a criminal context, the Fifth Circuit has held that a criminal defendant's right to counsel of his choice should be honored even if the trial court determines that the attorney should be disqualified due to confiict of interest. United States v. Garcia, 517 F.2d 272 (5th Cir. 1975). *But see* United States v. Inman, 483 F.2d 738 (4th Cir. 1973).

37. For expressions of the need for public confidence in the profession, see NCK Organization Ltd. v. Bregman, No. 76-7075 (2d Cir., Sept. 7, 1976); Emile Indus., Inc. v. Patentex, Inc., 478 F.2d 562, 564-65 (2d Cir. 1973). In E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969), the court dismissed the expense of retaining substitute counsel as insignificant when compared with the interests promoted by disqualification, which "vindicates the former client's trust in and reliance on his attorney" and "promotes the use of the legal system for tbe adjudication of disputes by upholding the dignity of the legal profession." *Id.* at 398.

It has been held, however, that public confidence is not a controlling consideration when the former client does not object to the adverse representation and unethical conduct is not manifest. *In re* Yarn Processing Patent Validity Litigation, 530 F.2d 83 (5th Cir. 1976); *cf.* United States v. Garcia, 517 F.2d 272 (5th Cir. 1975) (criminal defendant's right to counsel of choice outweighs the determination that counsel should be disqualified for confiict of interest).

38. *E.g.*, Hull v. Celanese Corp., 513 F.2d 568 (2d Cir. 1975) (defendant has a right to a trial free from the risk of even inadvertent disclosure).

interests rarely can provide an effective remedy,[39] litigants have sought immediate review of orders granting or denying disqualification under the *Cohen* doctrine. Because an order terminating the participation of an attorney would be moot on appeal from final judgment,[40] courts uniformly allow immediate review of orders granting disqualification under the *Cohen* doctrine.[41] Adopting a variety of approaches, virtually every court prior to the instant decision agreed that orders denying disqualification also should be considered final decisions subject to immediate review under the *Cohen* doctrine.

In *Tomlinson v. Florida Iron & Metal, Inc.*,[42] for example, the Fifth Circuit allowed appeal under *Cohen* of an order denying a disqualification request based on a statute forbidding certain former government employees to represent claimants against the United States.[43] Recognizing that the order was a final decision on an ancillary matter, the court reasoned that frustration of the public purpose evidenced by the statute would constitute a harm that could not be avoided or mitigated by appeal from final judgment.[44] Subsequent Fifth Circuit decisions, however, have relied on *Tomlinson* to review orders denying motions for disqualification on ethical grounds alone.[45] The Third Circuit has focused on the ineffective-

39. In E.F. Hutton & Co., v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969), the court examined the reasons for allowing immediate appeal from an order granting disqualification:

> A delayed appeal of this order of disqualification would be no appeal, for if plaintiff is required to obtain new counsel and try this suit before appealing the order of disqualification, the order will have become moot. Moreover, a principal reason for plaintiff's vigorous opposition to the motion is the delay and expense it will incur while new counsel are digesting the exhaustive files its present counsel have amassed; it would be unjust to subject plaintiff to this delay and expense as a price for an appeal of this order.

Id. at 402.

Generally, if an order denying disqualification is erroneous and constitutes prejudicial error, a judgment in favor of the subsequent client will be reversed and a new trial required. *See* United States v. Bishop, 90 F.2d 65 (6th Cir. 1937); Annot., 52 A.L.R.2d 1243, § 17 (1957). Requiring a new trial due to an issue collateral to the merits, however, proves so inefficient that courts rarely consider the correctness of the order on appeal from final judgment. *See* notes 73 & 74 *infra* and accompanying text. Additionally, a new trial cannot repair the breach of confidence or restore the right lost by the breach.

40. *See* E.F. Hutton & Co. v. Brown, 305 F. Supp. 371 (S.D. Tex. 1969); note 39 *supra*.

41. *See, e.g.*, Draganescu v. First Nat'l Bank, 502 F.2d 550 (5th Cir. 1974); Emile Indus., Inc. v. Patentex, Inc., 478 F.2d 562 (2d Cir. 1973); Allied Realty v. Exchange Nat'l Bank, 408 F.2d 1099 (8th Cir. 1969).

42. 291 F.2d 333 (5th Cir. 1961).

43. 5 U.S.C. § 99 (1958) (current amended version at 18 U.S.C. § 207 (1970)).

44. 291 F.2d at 334.

45. *See, e.g., In re* Yarn Processing Patent Validity Litigation, 530 F.2d 83 (5th Cir. 1976); Uniweld Prods., Inc. v. Union Carbide Corp., 385 F.2d 992 (5th Cir. 1967), *cert. denied*, 390 U.S. 921 (1968).

ness of appeal after final judgment to allow appeal of such orders under the *Cohen* doctrine.[46] Although the Second Circuit at one time recognized a distinction between the finality of orders granting and denying disqualification, this analysis has been abandoned. In *Fleischer v. Phillips*,[47] the court held that because orders denying disqualification are subject to reconsideration and reversal by the trial court, they are not final decisions.[48] Subsequently, however, the Second Circuit overruled this distinction in *Silver Chrysler Plymouth, Inc. v. Chrysler Motors Corp.*,[49] reasoning that the ineffectiveness of appeal after final judgment and the potential for irreparable harm required that such orders be considered final under the *Cohen* doctrine.[50] Although the Ninth Circuit adopted the *Fleischer* distinction, it nevertheless has used mandamus to allow immediate review of orders denying disqualification.[51] The Sixth[52] and Tenth[53] Circuits have followed the Second Circuit in allowing appeal, and the First[54] and Fourth[55] Circuits have indicated that they would

46. Greene v. Singer Co., 509 F.2d 750 (3d Cir. 1971). Although the *Greene* court stated that appeal under *Cohen* might not be appropriate in every case, appeal has been allowed in the following Third Circuit cases: Kramer v. Scientific Control Corp., 534 F.2d 1085 (3d Cir. 1976); Kroungold v. Triester, 521 F.2d 763 (3d Cir. 1975); American Roller Co. v. Budinger, 513 F.2d 982 (3d Cir. 1975).

47. 264 F.2d 515 (2d Cir.), *cert. denied*, 359 U.S. 1002 (1959), *overruled*, 496 F.2d 800 (2d Cir. 1974).

48. 264 F.2d at 517. It has been noted, however, that unless the attorney subsequently acts in a manner clearly requiring his disqualification, the trial court rarely reconsiders orders denying disqualification. *See* 1975 WASH. U.L.Q. 212, 225 n.39. Judge Moore dissented from the court's holding, reasoning that if on appeal from final judgment the appellate court determined that the order denying disqualification was erroneous, "the time spent in seeking an adjudication on the merits would thus have been wasted because of an error unrelated to the issues of tbe case." 264 F.2d at 518 (dissenting opinion).

49. 496 F.2d 800 (2d Cir. 1974) (en banc).

50. The court stated that orders denying disqualification of counsel have "grave consequences to the losing party, and it is fatuous to suppose that review of the final judgment will provide adequate relief."*Id.* at 805.

51. Chugach Elec. Ass'n v. United States Dist. Ct., 370 F.2d 441 (9th Cir. 1966); Cord v. Smith, 338 F.2d 516 (9th Cir. 1964), *clarified*, 370 F.2d 418 (9th Cir. 1966). *See* notes 28-31 *supra* and accompanying text.

52. Melamed v. ITT Continental Baking Co., 534 F.2d 82 (6th Cir. 1976).

53. Fullmer v. Harper, 517 F.2d 20 (10tb Cir. 1975). More recently, in New Mexico v. Aamodt, 537 F.2d 1102 (10th Cir. 1976), the Tenth Circuit specifically rejected any distinction between the appealability of orders granting and denying disqualification.

54. In Grinnell Corp. v. Hackett, 519 F.2d 595 (1st Cir.), *cert. denied*, 423 U.S. 1033 (1975), the First Circuit ruled that discovery orders are not subject to immediate review under tbe *Cohen* doctrine. Although relying on Second Circuit decisions that interpret *Cohen* to require that the issue on appeal have precedential value for many cases, *supra* note 21, the court noted:

> In *Silver Chrysler*, . . . the Second Circuit stated that the importance condition of *Cohen* is met in appeals from orders refusing to disqualify an attorney. If "importance" has the

consider orders denying disqualification final decisions under the *Cohen* doctrine.

The Court of Appeals for the District of Columbia Circuit first considered the appealability of an order denying disqualification in *Yablonski v. UMW,*[56] an action for accounting under the Landrum-Griffin Act.[57] Without stating the grounds for appeal, the court reversed the district court order refusing to disqualify a firm from representing the Union, although that firm continued to represent the defendant officers in several suits brought by the same plaintiff.[58] The court ruled that the high ethical standards established by the Act required completely objective representation of the Union's institutional interests.[59] When the district court subsequently allowed the UMW general counsel to replace the disqualified firm, plaintiff petitioned the Court of Appeals for a writ of mandamus ordering exclusion of the general counsel as well.[60] In granting the writ,[61] the court relied on *Tomlinson* to state that appeal of the original order denying disqualification had been appropriate under the *Cohen* doctrine since the request for disqualification was predicated upon a specific legislative policy.[62] The *Yablonski* court, how-

meaning given it in the [Second Circuit cases cited at note 21 *supra*] it is difficult to understand how every order refusing to disqualify is "important." But the *Silver Chrysler* result may reflect an overriding concern for judicial economy and for avoiding any interim appearance of impropriety. Such exceptional considerations are absent here. *Id.* at 597-98 n.4.

55. In United States v. Hankish, 462 F.2d 316 (4th Cir. 1972), the Fourth Circuit considered an appeal filed without indicating the jurisdictional grounds for review. Citing *Cohen* and Harmar Drive In Theatre, Inc. v. Warner Bros. Pictures, 239 F.2d 555 (2d Cir. 1956), *cert. denied,* 355 U.S. 824 (1957), which held that there was no distinction between orders granting and denying disqualification, the court noted that an appeal might be allowed if filed under § 1291.

56. 448 F.2d 1175 (D.C. Cir. 1971).

57. Labor-Management Reporting and Disclosure Act § 501(b), 29 U.S.C. § 501(b) (1970).

58. The firm in question, as regular counsel for the UMW, previously had represented both the Union and its officers in litigation. Although the firm withdrew from representing the officers in the instant suit, the district court allowed it to continue representing the Union.

59. 448 F.2d at 1177-80.

60. Petitioner sought review of the district court action because the UMW house counsel included the son of one of the defendants and three of the attorneys were named in the complaint as recipients of payoffs by the defendants. Yablonski v. UMW, 454 F.2d 1036, 1040 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 906 (1972). Rather than file another motion for disqualification in the district court, plaintiff's attorneys immediately petitioned for mandamus, which is appropriate to confine a lower court to the terms of an appellate mandate. *Id.* at 1038-39.

61. Yablonski v. UMW, 454 F.2d 1036 (D.C. Cir. 1971), *cert. denied,* 406 U.S. 906 (1972).

62. *Id.* at 1038 n.9. *See* notes 40-43 *supra* and accompanying text.

ever, did not determine the appealability of orders denying motions to disqualify counsel on ethical grounds alone. Although other circuits considering this question have allowed appeal under *Cohen* regardless of the grounds for disqualification, the instant case presented the first opportunity for the District of Columbia Circuit to clarify whether the *Cohen* doctrine would be applied to orders denying requests for disqualification on ethical grounds alone.

III. THE INSTANT OPINION

Focusing on the decisions of the Second Circuit,[63] the instant court reviewed the policy considerations supporting the final judgment rule and acknowledged the need for flexibility provided by the *Cohen* doctrine. Distinguishing *Yablonski* as being predicated upon special legislative considerations,[64] the court recognized that the Second, Third, Fifth, Sixth, and Tenth Circuits allow appeals of orders denying disqualification on ethical grounds under the *Cohen* doctrine.[65] Nevertheless, the instant court declined to follow the precedent established by these circuits and held that such orders are not subject to immediate review under section 1291.[66] Maintaining that charges of conflict of interest are easily alleged, the court reasoned that allowing appeals from orders denying disqualification would provide "yet another device" for delay and would force the court to police the ethics of the profession.[67] The court acknowledged

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

64. Although the instant court treated the appealability of orders denying motions to disqualify counsel on ethical grounds as an issue of first impression in the District of Columbia Circuit, several commentators and courts have cited *Yablonski* for the proposition that orders denying disqualification are subject to immediate review in the District of Columbia Circuit. *See, e.g.*, Fullmer v. Harper, 517 F.2d 20 (10th Cir. 1975); MOORE, *supra* note 23, at 37 (1975 Supp.).

65. *See* notes 42-54 *supra* and accompanying text.

66. 546 F.2d 1022, 1027 (D.C. Cir. 1976).

67. *Id.* The court also feared that interlocutory appeal "would lead the court to divert its attention from the central issues in the case." *Id.* Additionally, the court claimed that in response to the "flood of interlocutory appeals" after *Silver Chrysler*, the Second Circuit had narrowed the substantive grounds for disqualification. *Id.* & n.37. The cases cited by the court, however, apply the same standard that has always been required for disqualification: that participation by the attorney would taint the underlying proceeding. The court's reference to W.T. Grant Co. v. Haines, 531 F.2d 671 (2d Cir. 1976), and Lefrak v. Arabian Am. Oil Co., 527 F.2d 1136 (2d Cir. 1975) does not support the claim of a stricter standard. Courts long have recognized that an ethical violation, such as the solicitation of clients occurring in *Lefrak*, does not automatically taint the trial so as to require disqualification; in *W.T. Grant* the court specifically found that the challenged conduct did not constitute an ethical violation. 531 F.2d at 676. *See* Fisher Studio, Inc. v. Loew's Inc., 232 F.2d 199 (2d Cir.), *cert. denied*, 352 U.S. 836 (1956) (ethical violation by solicitation of clients does not automatically require disqualification). Hull v. Celanese Corp., 513 F.2d 568 (2d Cir. 1975), also cited for

that orders refusing to disqualify counsel on ethical grounds are collateral to the merits of the action as required by *Cohen*, but stated that the right involved would not be lost irreparably on appeal from final judgment.[68] Finally, the court noted that although the final judgment rule prohibits review under section 1291, mandamus is available in exceptional cases and discretionary appeal might be granted under section 1292(b) if the case presents a controlling question of law.[69]

IV. COMMENT

In ruling that the final judgment rule prohibits immediate appeal of orders denying disqualification on ethical grounds, the instant court elevates concerns for judicial economy over the possibility that a litigant might suffer irreparable harm. Moreover, by distinguishing between the appealability of statutory and ethical re-

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narrowing the substantive grounds for disqualification, actually relied on the rule from an earlier case that any doubt is to be resolved in favor of disqualification. *Id.* at 571 (citing Fleischer v. A.A.P., Inc., 163 F. Supp. 548, 553 (S.D.N.Y. 1958)).

68. The court justified this assumption by stating that the *Silver Chrysler* presumption of irrevocable taint arising from continued participation by the challenged attorney has been so eroded by the Second Circuit's decision in W.T. Grant v. Haines, 531 F.2d 671 (2d Cir. 1976), as virtually to preclude a finding of irreparable harm. 546 F.2d at 1028 n.39. The court reads *Grant* as imposing on the litigant the burden of proving taint in fact and actual personal injury. The problems of proof presented by this interpretation of *Grant*, however, would require the litigant to disclose the very information for which he seeks protection under the attorney-client privilege. In addition, the Second Circuit impliedly has refuted the instant court's claim that *Grant* requires a litigant to prove personal injury rather than mere harm to the judicial system by the "appearance of impropriety." In NCK Organization Ltd. v. Bregman, No. 76-7075 (2d Cir., Sept. 7, 1976), the court affirmed the disqualification of counsel, emphasizing that when there is some evidence that an attorney possibly disclosed information that he might have acquired in a prior representation, " 'the public's interest in maintaining the highest standards of professional conduct and the scrupulous administration of justice,' " as well as the litigant's interest in preventing use of the information, require disqualification. *Id.* slip op. at 5466-68 (quoting Hull v. Celanese Corp., 513 F.2d 568, 569 (2d Cir. 1975)).

Citing the Second Circuit decisions that have interpreted *Cohen* to require that the issue on appeal settle a matter arising in many cases, the instant court also noted the discussion of the *Cohen* doctrine's application to orders denying disqualification in Grinnell Corp. v. Hackett, 519 F.2d 595, 597-98 & n.4 (1st Cir.), *cert. denied*, 433 U.S. 1033 (1975); *see* note 54 *supra*. The instant court, however, chose to ignore that part of the *Grinnell* footnote stating that the *Silver Chrysler* treatment of orders denying disqualification "may reflect an overriding concern for judicial economy and for avoiding any interim appearance of impropriety." *Id.*

69. The court acknowledged, however, that no provision for certification of agency orders exists. 546 F.2d at 1028 n.40. Thus, in the absence of extraordinary circumstances justifying mandamus, any agency order denying a motion to disqualify would not be subject to immediate review. Additionally, the District of Columbia Court of Appeals has adopted an extremely restrictive view of mandamus. *See* Colonial Times, Inc. v. Gasch, 509 F.2d 519 (D.C. Cir. 1975).

quests for disqualification, the court arguably undermines the standards embodied in the Code of Professional Responsibility and relegates ethical violations to a position of secondary importance. Thus the precedential impact of the decision appears questionable in light of the criticism to which it is subject and the contrary results reached by the other circuits.

Analysis of the court's reasoning reveals several flaws. First, the court's fear of delay tactics does not justify ignoring the potential irreparable harm presented by an order erroneously denying disqualification. Once confidential information is divulged or utilized, it cannot be recalled.[70] Since subsequent disqualification or the granting of a new trial on appeal from final judgment would be ineffective to repair the breach, the litigant's right to a trial free from the disclosure of confidential information cannot be restored totally.[71] Thus, the instant court's claim that these rights will not be lost on appeal from final judgment appears unjustified.[72] In addition, it has been noted that appellate courts, which are hesitant to reverse collateral trial court orders and require new trials,[73] tend to ignore the issue of disqualification on appeal from final judgment.[74] Thus, although approximately fifty percent of the orders denying disqualification have been reversed in the circuits that allow imme-

70. Confidential information need not be divulged to cause irreparable harm. Even if an attorney does not actually divulge the confidential information that makes his participation wrongful, his mere possession of such information may influence the course of the litigation and taint consideration of the merits of the action.

71. *See* note 29 *supra* and accompanying text.

72. In Colonial Times v. Gasch, 509 F.2d 519 (D.C. Cir. 1975), the court noted that discovery orders, "while important to the general course of litigation, are often collateral to the litigation and thus lost to appellate review in fact if not in theory." *Id.* at 526. It has been noted that orders denying disqualification of counsel are similarly lost to appellate review. *See* Greene v. Singer Co., 509 F.2d 750, 751 (3rd Cir. 1971); 1975 WASH. U.L.Q. 212, 228 n.43.

73. In Herbst v. ITT, 495 F.2d 1308 (2d Cir. 1974), Judge Lumbard, arguing for immediate review of orders authorizing class actions, stated:

> We believe that in the exercise of our supervisory powers over the administration of justice in the district courts it is desirable for us to review orders authorizing class actions before the parties and the district courts expend large amounts of time and money in managing them. Candor compels us to add that as appellate judges we would be reluctant to hold that a class action had been improper after the district court and the parties had expended much time and resources although we might have had serious doubts if we had reviewed the question at the inception of the action. Judicial efficiency requires that appellate review be made before the parties and district courts have spent considerable time, effort, and money, on such actions.

Id. at 1313. Since post-judgment appeal of orders denying disqualification cannot provide an effective remedy for the litigant, this hesitancy to grant a new trial is even more justified.

74. *See* Greene v. Singer Co., 509 F.2d 750, 751 (3d Cir. 1971); Comment, 1975 WASH. U.L.Q. 212, 228 n.43.

diate appeal,[75] it is unlikely that an objective determination of the ethical considerations will prevail on appeal from final judgment. Furthermore, the court's reliance on the availability of mandamus or appeal by permission under section 1292(b) does not provide adequate protection for litigants. As noted by the Fourth Circuit, the use of mandamus to review orders denying disqualification is outside the traditional scope of the writ.[76] The application of section 1292(b) to such orders not only has been decided with confiicting results,[77] but reliance on the discretion of the trial court would not insure certification of novel or meritorious claims.[78] Since appeal after final judgment is ineffective to protect the litigant and the application of these alternative means of reviewing orders denying disqualification is questionable, the court's decision prohibiting immediate appeal under section 1291 can leave the litigant without an effective means of appeal or relief.

Secondly, while the conservation of judicial resources and the avoidance of delay are legitimate concerns, the result reached by the instant court does not necessarily promote these interests. Although post-judgment review of an order correctly refusing to disqualify counsel avoids the expense and the ten month delay usually resulting from appeal,[79] an appeal at the inception of the litigation would avoid the more costly duplication and expense required by a new trial if the order was erroneous. Because of the high reversal rate of orders denying disqualification,[80] immediate appeal may prove more economical by avoiding the inefficiency and expense required by

75. Of 22 cases in which disqualification was denied, 11 were reversed on appeal and two were remanded for a more complete record.

76. *See* notes 23-27 *supra* and accompanying text. In addition, in Colonial Times v. Gasch, 509 F.2d 519 (D.C. Cir. 1975), the court stated that the considerations of judicial economy that create the need for exceptions to the final judgment rule

> can not be permitted to authorize an *ad hoc* judgment on each mandamus petition to determine whether an exemption from the final judgment rule is warranted on the particular facts. Such a practice would be subversive of the very policy of the final judgment rule since every litigant would feel that his case is just such an exemption. Thus, this Court, even if it dismissed these potentially frivolous mandamus petitions, would be forced to expend the effort which it is the purpose of the final judgment rule to avoid. The final judgment rule is effctive only if it deters mandamus petitions in the first place. *Id.* at 523.

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

78. In discussing the appealability of orders authorizing class actions, Judge Lumbard expressed his preference for review under § 1291 rather than relying on discretionary certification under § 1292(b). Herbst v. ITT, 495 F.2d 1308, 1313 n.9 (2d Cir. 1974).

79. The median time for appeal is 10 months. Director of the Administrative Office of the United States Courts, 1975 Annual Report 336 (Table B-5).

80. *See* note 75 *supra* and accompanying text.

new trials.[81] Furthermore, appeals from such orders arise so infrequently that protection of the appellate court's docket does not require a general rule prohibiting immediate review.[82]

Finally, the instant court failed to consider the effect of its decision on public confidence in the profession. Denying immediate review to an order that potentially compromises the confidentiality of the attorney-client relationship could have a serious adverse impact on a client's incentive to make full disclosure to his attorney and on the public's confidence in the profession. In addition, the court's distinction between statutory and ethical grounds for disqualification appears questionable. The Code of Professional Responsibility, which seeks to promote ethical standards equally as high as those the court found required by the Landrum-Griffin Act,[83] should be fully enforced if public confidence in the profession is to be maintained. While disqualification requests generally are deemed to be within the discretion of the trial court, the reversal rate for such orders indicates that the trial court may not have a proper perspective for assessing objectively the ethical consequences. Although the court expressed fear that immediate review of ethical rulings would require it to police the profession, it failed to acknowledge that it performs this function on appeal from final judgment. By denying immediate appeal, the court seems to be abdicating its responsibility to supervise the ethics and conduct of attorneys before the bar. Since orders denying disqualification of counsel can harm the litigant irreparably and taint the merits of the action, the court has a responsibility to avoid these consequences by granting immediate appeal to such orders.

As recognized by the other circuits,[84] orders denying requests for disqualification on ethical grounds seem well within the intendment of the *Cohen* doctrine. Such orders implicate important collateral rights and can lead to irreparable harm. Since reevaluation of the

81. In view of the reversal rate of such orders when granted immediate review, the court's determination that post-judgment appeal of orders denying disqualification will conserve judicial resources implicitly recognizes the tendency of appellate courts to ignore the disqualification issue on appeal from final judgment. If the court intended to evaluate objectively the merits of each denial of disqualification on appeal from final judgment, it is arguable that post-judgment appeal would prove more inefficient and expensive than appeal at the inception of the litigation.

82. As noted, the instant case presented the first opportunity for the District of Columbia Circuit to consider the appealability of orders denying disqualification on ethical grounds since 1971.

83. *See* notes 56-62 *supra* and accompanying text.

84. *See* notes 42-55 *supra* and accompanying text.

merits of the disqualification requests rarely occurs prior to an actual breach of confidence, a practical construction of the final judgment rule does not prohibit immediate appeal. In addition, post-judgment review is ineffective to repair the breach of confidence and restore the litigant's right to a trial untainted by the confidential information. Although the final judgment rule is well-reasoned and necessary, it should not be construed technically if denying appeal would fail to protect important collateral rights and frustrate the ultimate goal of a just result.

SARA PORTER WALSH

Income Taxation — Interspousal Installment Sales — Taxpayers Required to Establish Purpose Other than Tax Avoidance to Qualify Under Section 453 of the Internal Revenue Code

I. FACTS AND HOLDING

Taxpayer sold separately owned stock to his wife in exchange for her longterm installment note[1] and reported his gain as an installment sale under section 453 of the Internal Revenue Code.[2] The

1. Under the terms of the installment sales contract, the wife agreed to pay $250,000 for the securities, plus 5% interest in monthly installments of $1,926.98 for a period of 15 years heginning on April 1, 1973.

2. I.R.C. § 453 provides in pertinent part:

(a) DEALERS IN PERSONAL PROPERTY.—

(1) IN GENERAL.—Under regulations prescribed by the Secretary or his delegate, a person who regularly sells or otherwise disposes of personal property on the installment plan may return as income therefrom in any taxable year that proportion of the installment payments actually received in that year which the gross profit, realized or to be realized when payment is completed, bears to the total contract price.

. . .

(b) SALES OF REALTY AND CASUAL SALES OF PERSONALITY.—

(1) GENERAL RULE.—Income from—

(A) a sale or other disposition of real property, or

(B) a casual sale or other casual disposition of personal property (other than property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year) for a price exceeding $1,000,

may (under regulations prescribed by the Secretary or his delegate) be returned on the basis and in the manner prescribed in subsection (a).

(2) LIMITATION.—Paragraph (1) shall apply—

(A) In the case of a sale or other disposition during the taxable year beginning after December 31, 1953 (whether or not such taxable year ends after the date of enactment of this title), only if in the taxable year of the sale or other disposition—

wife immediately resold the stock, purchased mutual fund shares to secure the note,[3] and subsequently made monthly sales of the mutual funds to satisfy her installment obligation.[4] The Commissioner disallowed use of the installment method on Taxpayers' joint return,[5] contending that the sale lacked substance and that the spouses had failed to establish a business purpose for the transaction. Taxpayers responded that section 453 treatment is not conditioned upon the existence of a business purpose and alternatively that the husband's desire to improve his investment return was a business motive.[6] On petition to the Tax Court of the United States, *held,* Commissioner's disallowance was correct. A purported installment sale by a husband to his wife, motivated solely by tax avoidance and followed immediately by the wife's disposition of the sale property, does not qualify for installment sales treatment under section 453 of the Internal Revenue Code. *Phillip W. Wrenn,* [1976] TAX CT. REP. DEC. (P-H) 305 (Dec. 23, 1976).

II. LEGAL BACKGROUND

Section 453 of the Internal Revenue Code permits taxpayers to report each year as income a pro rata amount of the installment payments received in that year in the proportion that the gross profit realized bears to the total contract price.[7] The provision evidences a congressional desire to allow the taxpayer to spread his gain over the years in which he receives installment payments

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(i) there are no payments, or

(ii) the payments (exclusive of evidences of indebtedness of the purchaser) do not exceed 30 per cent of the selling price.

3. On the same day that the wife acquired her husband's stock, she sold the stock on the open market for $250,874 and purchased Fidelity Trend Fund shares worth $250,000 as required under the security terms of the contract.

4. The wife had engaged in a regular program of monthly sales of mutual fund shares which was carefully structured to generate just enough cash to meet the monthly principal and interest payments.

5. Taxpayers had filed a joint federal income tax return for the calendar year 1973 using the cash receipts and disbursements method of accounting. They reported portions of the installment payments received by the husband during 1973 as long term capital gain in Schedule D of the return.

6. Taxpayers asserted that the transaction increased the husband's current return on investment from approximately 3% on the stock to 5% from the wife's interest payments.

7. I.R.C. § 453; Treas. Reg. § 1.453-1(b) (1958). For example, assume a taxpayer sells personal property with a basis of $8,000 for $10,000 pursuant to a contract that requires a $1,000 down payment and the balance in $1,000 installments over the following nine years. The taxpayer's gross profit is $2,000 ($10,000 less $8,000) and his contract price is $10,000; therefore, the reportable ratio is 20% (2,000/10,000). He will report $200 (20% of $1,000) of each yearly payment and thus have recognized the entire $2,000 gain at the end of the installment period.

rather than to require the taxpayer to pay tax in the year of sale on a gain which he has not realized economically.[8] Moreover, the gain spreading provision of section 453 enables the high bracket taxpayer to stagger receipts of long term capital gain in order to take full advantage of the alternative tax rate.[9] Thus section 453 helps to create markets for appreciated property that would not exist if tax consequences dictated full cash payment in the year of sale.

These advantages[10] have led taxpayers to seek the best of both worlds by enjoying use of the full sale price while deferring recognition of gain from the sale. For example, an investor might sell appreciated property on the installment method to a related party, who then would resell the property to an outsider for cash.[11] Because the taxpayer and the related party may constitute an economic unit, they thereby could obtain the tax advantage of installment treatment of the capital gain and at the same time could have the entire sales proceeds at their disposal.[12] Congress failed to foresee this abuse when section 453 was enacted[13] and subsequently has chosen not to include installment sales within Internal Revenue Code provisions designed to prevent tax abuses by means of related-party transactions.[14] Consequently, the courts have been compelled to

8. *See* Commissioner v. South Tex. Lumber Co., 333 U.S. 496, 503 (1948); S. & L. Bldg. Corp. v. United States, 60 F.2d 719 (2d Cir. 1932), *rev'd on other grounds*, 288 U.S. 406 (1933); Gralapp v. United States, 319 F. Supp. 265, 267 (D. Kan. 1970); S. REP. No. 52, 69th Cong., 1st Sess. 19 (1926).

9. Prior to the Tax Reform Act of 1969, all of an individual's long term capital gains could be taxed by including one half of the gains in his income to be taxed at ordinary rates. The taxpayer had the option, however, of having the entire gain taxed separately from his other income at the 25% alternative rate. An individual whose average tax bracket exceeded 50% could utilize the alternative rate and pay less tax than he would by including one-half of the capital gain in his income to be taxed at the normal rate. Section 1201 now permits only the first $50,000 of long term capital gain recognized each year to qualify for the maximum 25% alternative rate, with the balance subject to the regular tax rates up to a maximum effective rate of 35% (the maximum 70% rate on one-half the gain). Thus it is possible to effect a tax saving of up to 10% by restricting recognition of long term capital gain to $50,000 each year. *See* Tripp, *Installment Sales to Related Parties*, 52 TAXES 261 (1974) [hereinafter cited as Tripp]. The taxpayer must also consider the effect of the minimum tax before making an installment election.

10. For a discussion of the advantages and disadvantages of the use of section 453, see TAX MNGM'T (BNA), PORTFOLIO No. 48-4th (1975).

11. *See, e.g.*, Hindes v. United States, 214 F. Supp. 583 (W.D. Tex. 1963), *rev'd and remanded on other grounds*, 326 F.2d 150 (5th Cir. 1964); Rev. Rul. 73-157, 1973-1 C. B. 213.

12. *See* Tripp, *supra* note 9, at 262.

13. *See* S. REP. No. 52, 69th Cong., 1st Sess. 19 (1926).

14. *See, e.g.*, I.R.C. § 267 (denying loss recognition to transactions between related parties), § 318 (attrihuting constructive stock ownership to related parties), § 677(b) (requiring grantor to report income from trust established for spouse), § 1235 (denying capital gains treatment when transferee of patent is a family member), and § 1239 (denying capital gains

determine the proper tax treatment of a purported installment sale between related parties followed by a disposition of the sale property to a third person.

The courts have invoked a variety of judicial weapons to combat abuses of section 453 by related taxpayers. The first tactic employed by the judiciary was the substance over form doctrine, which provides that economic reality rather than outward appearance determines the tax treatment of a transaction.[15] Thus in *Griffiths v. Commissioner*,[16] the Supreme Court disallowed installment treatment to a sale of stock between a taxpayer and his controlled corporation. Since the corporation had immediately resold the stock to a third party, the Court found that the entire transaction was in substance a direct sale by the taxpayer to the third party.[17]

Recent decisions have employed the doctrine of constructive receipt[18] in denying section 453 treatment to related-party sales. In *Everett Pozzi*,[19] for example, the purchaser of a business placed an amount of money equal to the sales price in escrow for release to taxpayers annually over a ten-year period. Because the taxpayers had the ability to command receipt of the entire sale price at the time they transferred the property, the Tax Court held that the taxpayers had constructively received the full sale proceeds and thus must include all the gain in their taxable income for the current year.[20] The court confused the impact of its holding, however, by announcing that a vendor's mere insistence on installment payments would not prevent the application of section 453 if the parties constructed a bona fide installment sale.[21] Thus *Pozzi* failed to explain clearly the circumstances in which the constructive receipt

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treatment when depreciable property is sold to a spouse or controlled corporation). *See also* I.R.C. § 1313; Bittker, *Federal Income Taxation and the Family*, 27 STAN. L. REV. 1389, 1456-63 (1975).

15. *See generally* Cuddihy, *The Misuse of "Substance" v. "Form"*, 15 U.S. CAL. 1963 TAX INST. 653 (1963); Fuller, *Business Purpose, Sham Transactions and the Relation of Private Law to the Law of Taxation*, 37 TUL. L. REV. 355 (1963).

16. 308 U.S. 355 (1939).

17. *Id.* at 357.

18. *See* Treas. Reg. § 1.451-2(a) (1957), providing in part:

> Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, *set apart for him, or otherwise made available to him* so that he may draw upon it at any time . . . .

Id. (emphasis added). *See also* Comment, *Receipt of Deferred Payment Contracts as Income to the Cash Basis Taxpayer*, 58 NW. U.L. REV. 278 (1963).

19. 49 T.C. 119 (1967).

20. *Id.* at 127.

21. *Id.* at 128.

doctrine would be employed to deny use of section 453. The Tax Court has subsequently clarified the application of the constructive receipt doctrine in *J. Earl Oden.*[22] After finding that the parties contemplated payment solely from certificates of deposit placed in escrow ostensibly as security for an installment obligation, the court concluded that the certificates constituted full payment rather than security and that the seller therefore constructively received all the sales proceeds in the year of the sale.[23] Under the standard developed in *Oden,* even if the parties construct an actual installment sale, their contemplation that payment of purported installment obligations will be satisfied from the deposited security rather than from the purchaser's personal obligation will result in disallowance of section 453 treatment under the constructive receipt doctrine. Thus the courts have looked to the existence of a sham transaction rather than to the relationship between the buyer and seller in denying installment sales treatment to related parties.

When installment sales between related parties do have substance, the courts traditionally have permitted the use of section 453. Thus in *Rushing v. Commissioner,*[24] the Fifth Circuit allowed the advantages of section 453 for the sale to an irrevocable family trust of stock in a wholly owned corporation that had adopted a complete liquidation plan. After the trustee as sole shareholder completed liquidation, the government attempted to tax the sellers on the liquidating distribution under a theory of constructive receipt. The court rejected this argument, finding that the trustee was completely independent of the taxpayers' control and that therefore the sellers could not possess directly or indirectly the economic benefit from the distribution.[25] Similarly, the recent case of *Nye v. United States*[26] approved section 453 treatment for an interspousal installment sale. In *Nye* the taxpayer persuaded his wife to sell securities to him under an installment sales agreement so that he could resell the shares and obtain funds to repay a debt. Adopting the rationale used in *Rushing,*[27] the court found that the spouses

22. 56 T.C. 569 (1971).
23. *Id.* at 576-77.
24. 441 F.2d 593 (5th Cir. 1971).
25. *Id.* at 598.
26. 407 F. Supp. 1345 (M.D.N.C. 1975), *noted in* 54 N.C.L. REV. 714 (1976).
27. The *Rushing* court stated:

> We think it clear from a reading of these cases that a taxpayer may, if he chooses, reap the tax advantages of the installment sales provisions if he actually carries through an installment sale, even though this method was used at his insistence and was designed for the purpose of minimizing his tax. On the other hand, a taxpayer certainly

were separate economic units and held that the wife did not constructively receive the proceeds of her husband's sale.[28] Thus prior to the instant case, courts had approved the use of section 453 in related-party transactions so long as the seller received the sale proceeds solely on the installment basis and realized no economic benefit upon the buyer's subsequent disposition of the sale property.

III. The Instant Opinion

The instant court initially observed that section 453 is to be construed narrowly since it is a relief provision[29] exempting installment sales from the general rule requiring income to be reported in the year of realization.[30] Although recognizing that the fact that parties to an installment sale are married alone is an insufficient ground for denying section 453 relief, the court nevertheless concluded that the inherent potential for tax avoidance dictated close scrutiny of interspousal installment sales. Citing *Nye v. United States,* the instant court emphasized that the spouses in *Nye* were independent economic entities with distinct purposes for engaging in the installment sale.[31] The instant court thus held that a bona fide installment sale between spouses exists under section 453 only when taxpayers demonstrate a substantive purpose[32] other than tax avoidance.[33] Applying this test, the court concluded that the wife

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may not receive the benefits of the installment sales provisions if, through his machinations, he achieves in reality the same result as if he had immediately collected the full sales price, or, in our case, the full liquidation proceeds. As we understand the test, in order to receive the installment sale henefits the seller may not directly or indirectly have control over the proceeds or possess the economic benefit therefrom.

441 F.2d at 598 (citations omitted).

28. 407 F. Supp. at 1349. The Internal Revenue Service has taken a contrary position in Rev. Rul. 73-536, 1973-2 C. B. 158.

29. *See* Cappel House Furnishing Co. v. United States, 244 F.2d 525, 529 (6th Cir. 1957).

30. I.R.C. § 451(a) provides:

The amount of any item of gross income shall he included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

31. *See* text accompanying note 28 *supra.*

32. The court rejected the Commissioner's contention that taxpayers must establish a business purpose for the transaction, finding instead that more personal motivations could indicate the existence of a bona fide installment sale. [1976] Tax Ct. Rep. Dec. (P-H) 305, 308 (Dec. 23, 1976).

33. A related issue in which the Tax Court has required activity motivated by considerations other than pure tax savings is the deductihility of interest under § 163(a). Goldstein v. Commissioner, 44 T.C. 284 (1965), *aff'd,* 364 F.2d 734 (2d Cir. 1966), *cert. denied,* 385 U.S. 1005 (1967), *noted in* 19 Vand. L. Rev. 194 (1965). *See generally* Lipnick, *Business Purpose and Income Taxes: From Gregory to Goldstein,* 46 Taxes 698 (1968).

did not purchase the securities for their intrinsic value or to satisfy personal obligations since she immediately resold the stock to purchase the mutual funds as security.[34] The court also found that the husband's desire to increase the return on his investment in itself was insufficient to legitimate the transaction. Because the taxpayers failed to establish a significant purpose other than tax avoidance for entering into the transaction, the court therefore denied Taxpayers use of section 453 on their joint return.

IV. COMMENT

The instant case marks a clear shift in judicial analysis of section 453 installment sales between related taxpayers. The Tax Court has indicated clearly that it no longer will be satisfied by a showing that the purchaser is independent of the vendor and that an actual installment sale has occurred.[36] Now the taxpayer must also establish that the transaction was not entered into solely for tax avoidance purposes.[37] That the Tax Court chose the instant case to introduce a more rigid standard is surprising since the court could have reached the same result using the *Oden* constructive receipt analysis.[38] The husband obviously expected payment from the mutual funds posted as "security" and did not look to the wife's personal obligation for payment; therefore, a finding that the husband constructively received the funds would have been justified fully under *Oden*.

Moreover, this newly imposed burden for establishing the validity of an interspousal installment sale appears undesirable for several reasons. First, the substantive purpose requirement creates a trap for the unwary taxpayer selling property to a related party, because an installment sale involving independent taxpayers and containing no evidence of sham may be denied the advantages of section 453 if the taxpayer fails to prove a motive other than tax avoidance.[39] Secondly, since the court's reasoning clearly is limited to sales between related taxpayers,[40] an identical sale made to an unrelated taxpayer solely to avoid taxes will qualify for installment treatment. Thus application of the instant court's substantive pur-

34. [1976] TAX CT. REP. DEC. (P-H) at 308-09.
35. *Id.* at 309.
36. *See* notes 24-28 *supra* and accompanying text.
37. *See* notes 31-33 *supra* and accompanying text.
38. *See* notes 22 & 23 *supra* and accompanying text.
39. *See* notes 31-33 *supra* and accompanying text.
40. *See* text following note 30 *supra*.

pose requirement results in discrimination against related taxpayers. Thirdly, since Congress has not included section 453 within the provisions of the Internal Revenue Code expressly disallowing tax advantages to related parties,[41] it is fair to infer a legislative intent that related parties be allowed to share benefits on an equal basis with unrelated taxpayers.[42]

Finally, the instant case creates uncertainty for a taxpayer seeking to report his gain on an installment sale to a related party under section 453 by undermining the reliable guidelines developed by prior case law. Prior to the instant decision, related parties could assume that an installment sale would qualify for section 453 treatment if the parties posessed economic independence,[43] looked solely to the purchaser's personal obligation for payment,[44] and precluded the seller from receiving any economic benefit except on the installment basis.[45] The instant court's imposition of the vague substantive purpose doctrine[46] greatly reduces the tax certainty developed by these concrete standards. The court's holding that a desire to purchase property for its intrinsic value is a legitimate nontax motive while a desire to improve return on investment is not[47] illustrates the uncertainties produced in the absence of clear guidelines. As a result of these uncertain tax consequences, related taxpayers will be discouraged from engaging in installment sales.

The present case thus represents a significant restriction on the use of section 453. While the substantive purpose requirement effectively discourages those who seek to abuse the relief afforded by section 453, it does so by penalizing legitimate installment sales between related parties.

DON B. CANNADA

41. *See* note 14 *supra* and accompanying text.

42. The First Circuit used this analysis in Fabreeka Prod. Co. v. Commissioner, 294 F.2d 876 (1st Cir. 1961), in which the taxpayer was allowed a deduction for bond premium amortization although the bonds were acquired solely for tax avoidance. The court concluded that:

> The brightness of the motive cannot be permitted to blind our eyes to the existence of substantive events . . . . Nevertheless, unless Congress makes it abundantly clear, we do not tbink tax consequences should be dependent upon the discovery of a purpose, or a state of mind, whether it be elaborate or simple. . . . Granting the government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for application of the Congressional thumb, not the court's.

294 F.2d at 878-79.

43. *See* notes 24-28 *supra* and accompanying text.

44. *See* notes 22 & 23 *supra* and accompanying text.

45. *See* notes 18-20 *supra* and accompanying text.

46. *See generally* Lipnick, *Business Purpose and Income Taxes: From Gregory to Goldstein*, 46 TAXES 698 (1968).

47. *See* notes 34 & 35 *supra* and accompanying text.

Securities Regulation—Courts Disagree Whether SEC Must Allege and Prove Scienter in Injunctive Actions Under Section 10(b) and Rule 10b-5

I. INTRODUCTION

In *Ernst & Ernst v. Hochfelder*,[1] the Supreme Court resolved a conflict among the circuits[2] by holding that in a private action for damages under section 10(b)[3] and rule 10b-5,[4] plaintiff must allege and prove scienter[5] and not mere negligence.[6] The Court qualified its intentional misconduct requirement by leaving two questions

1. 425 U.S. 185 (1976).

2. For circuit court decisions holding in essence that negligence would suffice to establish civil liability under section 10(b) and rule 10b-5, see, *e.g.*, White v. Abrams, 495 F.2d 724, 730 (9th Cir. 1974) ("flexible duty" standard); Myzel v. Fields, 386 F.2d 718, 735 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968) (negligence); Kohler v. Kohler Co., 319 F.2d 634 (7th Cir. 1963) (knowledge not required). For circuit court decisions requiring some type of scienter in such actions, see, *e.g.*, Clegg v. Conk, 507 F.2d 1351, 1361-62 (10th Cir. 1974), *cert. denied*, 422 U.S. 1007 (1975) ("scienter or conscious fault"); Lanza v. Drexel & Co., 479 F.2d 1277, 1306 (2d Cir. 1973) ("willful or reckless disregard" for the truth). For an analysis concluding that most decisions announcing a negligence standard for civil liability have involved more than negligent conduct, see Bucklo, *Scienter and Rule 10b-5*, 67 NW. U.L. REV. 562, 568-70 (1972).

3. Section 10(b) of the Securities Exchange 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.

4. 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.

5. In *Hochfelder* the Supreme Court defined scienter under section 10(b) and rule 10b-5 as "a mental state embracing intent to deceive, manipulate, or defraud." 425 U.S. at 193-94 n.12.

6. Hochfelder had alleged only that Ernst & Ernst was negligent in conducting audits and in failing to discover the fraudulent scheme of its client's president and that such negligence had aided and abetted the fraudulent scheme. *Id.* at 190.

unanswered: whether scienter is a necessary element in an injunctive action and whether recklessness might constitute scienter and suffice to establish liability under section 10(b) and rule 10b-5.[7] Two recent decisions addressing primarily the first question, and the second as it relates thereto, have reached apparently conflicting results.[8] The Southern District of New York in *SEC v. Bausch & Lomb, Inc.*[9] held that the Securities and Exchange Commission must allege and prove scienter in an injunctive action[10] brought under section 10(b) and rule 10b-5; the First Circuit in *SEC v. World Radio Mission, Inc.*[11] urged that this requirement should not be imposed upon the Commission. An analysis of these two cases first requires an examination of the prior judicial reasoning that developed a different securities fraud standard for SEC injunctive actions than for private damage actions and secondly requires a determination whether that rationale can or should retain viability after *Hochfelder*.

II. Legal Background

The cornerstone for the concept that the elements of securities fraud vary according to the nature of relief sought is *SEC v. Capital Gains Research Bureau, Inc.*[12] Pursuant to a statutory provision[13] proscribing fraud and deceit by investment advisers, the Supreme

7. *Id.* at 194 n.12.

8. *See* text accompanying notes 50-53 & 68-71 *infra*.

9. 420 F. Supp. 1226 (S.D.N.Y. 1976).

10. The SEC has specific statutory authority to seek injunctive relief against violations of the 1934 Act. Section 21(d) of the 1934 Act provides in pertinent part:

> Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this chapter, the rules or regulations thereunder, . . . it may in its discretion bring an action in the proper district court of the United States, . . . to enjoin such acts or practices, and upon a *proper showing* a permanent or temporary injunction or restraining order shall be granted without bond . . . .

15 U.S.C.A. § 78u(d) (Supp. 1976) (emphasis added). The "proper showing" requires evidence of a "reasonable likelihood" that the defendant will commit future violations. SEC v. Management Dynamics, Inc., 515 F.2d 801, 807 (2d Cir. 1975); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100-01 (2d Cir. 1972).

11. 544 F.2d 535 (1st Cir. 1976).

12. 375 U.S. 180 (1963).

13. Section 206(2) of the Investment Advisers Act of 1940, 15 U.S.C. § 80b-6(2) (1970), provides:

> It shall be unlawful for any investment adviser,
>
> . . .
>
> (2) to engage in any transaction, practice or course of business which operates as a fraud or deceit upon any client or prospective client.

Court enjoined an adviser's practice of secretly "scalping"[14] clients, even though plaintiff did not prove intent to injure clients. Emphasizing the overall purpose of the securities acts to promote disclosure and the fiduciary nature of the investment advisory relationship,[15] the Court observed that it was "not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."[16]

The Second Circuit,[17] beginning with Judge Friendly's concurrence in *SEC v. Texas Gulf Sulphur Co.*,[18] developed the *Capital Gains* concept in the context of section 10(b) and rule 10b-5. Judge Friendly recognized that to impose private damage liability for a negligent press release would produce "frightening" consequences[19] and probably would be inconsistent with the language of section 10(b) and the general scheme of the securities acts.[20] Relying, however, on the broad purpose of securities legislation to protect investors against circulation of improper information, Judge Friendly was willing to recognize a negligence standard in SEC injunctive actions since it would "be of such great public benefit and do so little harm to legitimate activity."[21] Consistent with Judge Friendly's distinction, subsequent decisions by the Second Circuit and its district courts relied on the specific langnage of section 10(b) to impose a scienter requirement in private damage actions. Illustrative of these decisions is *Lanza v. Drexel*,[22] which held that an outside director's failure to discover misleading statements and omissions by insiders negotiating an exchange of stock did not es-

14. The investment adviser was buying securities for his own account shortly before recommending that security for a long-term investment, and then selling the securities at a profit when the market price rose in response to the recommendation.

15. 375 U.S. at 186, 193-95.

16. 375 U.S. at 193.

17. At least two other circuits have given some attention to the issue whether a lesser standard of culpability would suffice in SEC injunctive actions, as distinct from private actions, under section 10(b) and rule 10b-5. In SEC v. Coffey, 493 F.2d 1304 (6th Cir. 1974), *cert. denied*, 420 U.S. 908 (1975), the Sixth Circuit recognized that *Capital Gains* might require a lesser standard in an SEC injunctive action, but nevertheless held that the SEC must show willful or at least reckless disregard for the truth. The Tenth Circuit, in a case in which the defendant seemed unlikely to repeat antifraud violations, refused to categorize the trial court's denial of a preliminary injunction as an abuse of discretion, but did observe that proof of scienter or intent to defraud would not have been essential to show violations justifying preliminary injunctive relief. SEC v. Pearson, 426 F.2d 1339 (10th Cir. 1970).

18. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

19. 401 F.2d at 866.

20. *Id.* at 867.

21. *Id.* at 868. Subsequent decisions reflect a greater concern for the consequences of an injunction. *See* note 25 *infra*.

22. 479 F.2d 1277 (2d Cir. 1973).

tablish liability for damages, absent a showing of actual knowledge of the deception or "willful, deliberate, or reckless disregard for the truth that is the equivalent of knowledge."[23] In SEC injunctive actions, however, the Second Circuit courts relied on broad policy considerations and flexible statutory construction to justify a negligence standard for establishing violations. Upon finding violations, the courts then avoided unjustified injunctions by employing their discretion to determine the reasonable likelihood of future violations[24] and to balance the equities.[25] Thus in *SEC v. Manor Nursing Centers, Inc.*,[26] the negligent failure of certain selling shareholders to discover that the terms of an offering were not being satisfied constituted a violation of section 10(b) and rule 10b-5. The court, however, limited the injunction to those more knowingly involved in the fraudulent offering because the selling shareholders' good faith violations were not likely to be repeated. In contrast, *SEC v. Lum's*[27] held that a chief executive officer's honest, but unreasonable, practice of "confidential" disclosures to a particular broker-dealer salesman justified injunctive relief because the conduct posed a substantial and obvious danger to the public.[28] To justify

23. *Id.* at 1305; *accord,* Katz v. Realty Equities Corp., 406 F. Supp. 802, 805 (S.D.N.Y. 1976).

24. *See* note 10 *supra.*

25. In determining the appropriateness of an injunction, courts view proof of a past violation as highly relevant to the likelihood of future violations and give primary importance to the public interest in a fair market. SEC v. Management Dynamics, Inc., 515 F.2d 801, 807-09 (2d Cir. 1975) (public interest protected by SEC is paramount when in conflict with private interests). Among the other factors considered are whether defendant's past violation was an isolated occurrence or part of a continuing practice; whether defendant asserts his innocence or adopts procedures to avoid future violations; whether defendant is sincere; whether defendant's conduct was intentional, reckless, or merely negligent; whether there is opportunity for future violations in defendant's present position; and whether defendant will he harmed substantially by an injunction. SEC v. Spectrum, Ltd., 489 F.2d 535, 542 (2d Cir. 1973) (existence of scienter is "highly relevant" to likelihood of future violations); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100-01 (2d Cir. 1972); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1066-67 (S.D.N.Y. 1973).

Among the important consequences of an injunction, which the court must weigh, are: risk of criminal contempt charges for violation of the injunction; disqualification under Regulation A of the Securities Act of 1933; possible censure, suspension, revocation, or bar of broker-dealer or investment adviser registration under the 1934 Act or the Investment Advisers Act of 1940; disqualification or suspension of attorneys and other professionals from practicing before the SEC; and mandatory public disclosure through various filings. *Program of the Committee on Federal Regulation of Securities — SEC Civil Injunction Relief,* 30 BUS. LAW. 1303 (1975).

26. 458 F.2d 1082 (2d Cir. 1972).

27. 365 F. Supp. 1046 (S.D.N.Y. 1973).

28. *Id.* at 1066. In return for advice on making Lum's more attractive to the investment community, Lum's chief executive officer kept the salesman advised, on what he believed to

their broad policy approach to SEC injunctive actions, the Second Circuit courts provided little independent analysis, instead relying primarily on repeated citations to *Capital Gains* and to the growing body of precedent within the circuit.[29]

The Supreme Court's rationale in *Hochfelder* has drawn into question future reliance on broad policy considerations and overall statutory purposes to justify different standards of culpability in private damage actions and SEC injunctive actions under section 10(b) and rule 10b-5. The *Hochfelder* Court based its requirement of scienter in private damage actions primarily on its finding that the specific language[30] of section 10(b) was directed at knowing or intentional misconduct beyond mere negligence.[31] The Court refused to give a more expansive construction to the broader language[32] of rule 10b-5 because the rule originally was directed at conduct involving scienter[33] and, more importantly, was limited to

be a confidential basis, of new developments so that the salesman would not appear unprepared when Lum's released such information publicly.

29. *See, e.g.*, SEC v. Spectrum, Ltd., 489 F.2d 535, 541 (2d Cir. 1973); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1095-96 (2d Cir. 1972); SEC v. Lum's, Inc., 365 F. Supp. 1046, 1057-58 (S.D.N.Y. 1973).

30. Particularly significant to the Court was § 10(b)'s use of the word "manipulative," a term of art used in a securities market context to connote "intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." 425 U.S. at 199.

31. The Court found that the sparse legislative history reinforced this construction of section 10(b). Most relevant was an explanation by Thomas G. Corcoran, one of the draftsmen:

> Subsection (c) [now § 10(b)] says, "Thou shalt not devise any other cunning devices" . . . .
>
> Of course subsection (c) is a catch-all clause to prevent manipulative devices. . . . The Commission should have the authority to deal with new manipulative devices.

425 U.S. at 202-03, citing *Hearings on H.R. 7852 and H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 115 (1934).

The Court also explained that the express provisions in the Securities Act of 1933 imposing civil liability for certain negligent conduct contain significant procedural restrictions, *e.g.*, bond requirements and an explicit, relatively short statute of limitations, that should not be nullified by allowing private plaintiffs to sue on a negligence theory under section 10(b)'s judicially created remedy, which has no comparable procedural restrictions. 425 U.S. at 207-10. If this factor were critical to the Court's conclusion, SEC injunctive actions could he exempted easily from the scienter requirement. But this factor does little more than reinforce a conclusion based primarily on the statutory langnage and legislative history of section 10(b).

32. The SEC in its amicus curiae brief had contended that the broad proscriptions of subsections (2) and (3) of the rule could encompass both intentional and negligent conduct. The Court rejected this construction as inconsistent with the rule's total context, although "arguably" correct if the language were read in isolation. 425 U.S. at 212-14.

33. The rule was drafted hastily and approved in one day to enable the SEC to take action against the intentional misconduct and self-dealing of a corporate president. *Id.* at 212-13 n.32; *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 793, 922 (1967).

the scope of its underlying statutory authority. Urging the Court not to adopt a scienter requirement, the SEC reasoned that section 10(b) should be construed in light of an overall congressional purpose to protect investors against the injurious effect of fraudulent and deceptive practices and that the injurious effect was the same whether the conduct was negligent or intentional. The Court rejected this argument, explaining that such "effect-oriented" logic would extend liability to faultless conduct and would iguore the particularized standard of culpability clearly required by the language of section 10(b).[34] Other than suggesting that *Capital Gains* might provide a helpful analogy,[35] the *Hochfelder* Court offered little guidance for reconciling a policy-justified negligence standard in SEC injunctive actions with the stricter and more explicit language of section 10(b), which was drafted in contemplation of enforcement by statutory SEC injunctions and not by judicially implied private remedies.[36] Although the *Hochfelder* Court found it unnecessary to consider policy issues,[37] the SEC's general counsel has suggested[38] that the negligence standard in Commission injunctive actions might be preserved by characterizing *Hochfelder* as part of a recent Supreme Court trend[39] limiting private actions under the securities acts without affecting Commission actions.

In contrast to the relatively general antifraud proscriptions in existing legislation, the proposed ALI Federal Securities Code employs a more particularized approach to fraudulent, deceptive, and manipulative practices and recognizes that a more flexible standard of culpability is appropriate for SEC injunctive actions than for private damage actions. Part XIII makes various deceptive and manipulative acts unlawful, without prescribing the requisite de-

34. 425 U.S. at 198-99.

35. *Id.* at 194 n.12.

36. *Id.* at 196. *See also* note 31 *supra.*

Rule 10b-5 also was drafted with SEC injunctions, not private remedies, in mind. *Conference on Codification of the Federal Securities Laws*, 22 BUS. LAW. 973, 922 (1967).

37. The Court asserted tbat the language and history of section 10(b) were "dispositive of tbe appropriate standard of liability," but observed that if policy considerations were necessary, the issue of indeterminable liability for damages would be a central concern. 425 U.S. at 214-15 n.33.

38. SEC General Counsel's Memorandum Regarding Ernst & Ernst v. Hochfelder, SEC. REG. & L. REP. (BNA) No. 354, at F-1 (May 26, 1976) (addressed to all SEC staff attorneys).

39. *Id.* at F-2 to -3. The Memorandum cited Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975) (adopting the *Birnbaum* purchaser-seller limitation on standing to sue for private damages under rule 10b-5), and Rondeau v. Mosinee Paper Corp., 422 U.S. 49 (1975) (requiring a private litigant to show irreparable harm to obtain injunctive relief against a violation of section 13(d) of the 1934 Act).

gree of culpability.[40] Civil liability for these unlawful acts is governed by Part XIV, which specifies the degree of scienter or negligence required for each type of violation. Thus negligence suffices to establish civil liability for trading with inside information,[41] but knowledge,[42] which may be imputed by recklessness, is required to establish civil liability for false publicity.[43] In contrast, Part XV, dealing with administration and enforcement, contains no scienter requirements in the section authorizing the grant of injunctive relief sought by the SEC against violations.[44] Instead, to avoid inappropriate injunctions, the Code relies on agency discretion,[45] on the need to prove an existing or impending violation or a reasonable likelihood of repetition of a past violation, and ultimately on judicial discretion.[46]

Unaided by the particularized approach of the proposed Code, however, the courts in *Bausch & Lomb* and *World Radio Mission* confronted the question whether the Supreme Court's recent construction of section 10(b) permits continued reliance on policy distinctions to justify a negligence standard in SEC injunctive actions.

III. THE INSTANT DECISIONS

In *Bausch & Lomb* the SEC sought to enjoin[47] permanently the corporate defendant and its board chairman, Schuman, from violating section 10(b) and rule 10b-5. The SEC charged that Schuman's inadvertent and uncharacteristic leak of a nonpublic earnings projection to a financial analyst constituted a tipping violation,[48]

40. ALI FED. SEC. CODE § 259(a), Comment (3)(c) (Tent. Draft No. 2, 1973).

41. *Id.* § 1402.

42. *Id.* § 251A.

43. *Id.* § 1406.

44. *Id.* § 1515 (Tent. Draft No. 3, 1974).

45. *See also* Professor Loss's observation that as a practical matter the SEC rarely institutes injunctive proceedings based on innocent misrepresentations for which a warning will suffice. 6 L. LOSS, SECURITIES REGULATION 4116 (2d ed. Supp. 1969). The SEC's zeal in *Bausch & Lomb* seems to be an exception to this general rule. *See* notes 47-57 *infra* and accompanying text.

46. ALI FED. SEC. CODE § 259(a), Comment (3)(c) (Tent. Draft No. 2, 1973); *Id.* § 1515 (Tent. Draft No. 3, 1974).

47. The SEC also sought an affirmative order requiring defendants to establish written procedures to assure that future leaks of inside information in violation of section 10(b) and rule 10b-5 would not occur. 420 F. Supp. at 1245.

48. Shortly after Schuman's meeting with financial analyst McCallum, it was improperly rumored that Schuman had released a $.60 per share first quarter earnings estimate. In his haste to correct McCallum and to make public a $.65 to $.75 per share official estimate, Schuman reported the official estimate to McCallum prior to the time it became public. Soon after the disclosure to McCallum, a member of McCallum's firm sold 3,000 shares of Bausch & Lomb stock. 420 F. Supp. at 1237-39.

notwithstanding Schuman's immediate corrective measures.[49] Determining that an "identical standard" of culpability must be applied under section 10(b) and rule 10b-5 regardless of whether the SEC or a private litigant is the plaintiff,[50] the court held that Schuman's conduct clearly lacked scienter and thus constituted no violation. The court reasoned that the *Hochfelder* analysis, based on statutory language and on legislative and administrative history, clearly applied to SEC injunctive actions.[51] The court then concluded that the policy considerations used by the Second Circuit courts to distinguish SEC injunctive actions from private damage actions[52] had lost their relevancy since the *Hochfelder* Court had found "the language and history of § 10(b) dispositive of the appropriate standard of liability" and had refused the parties' invitation to consider policy distinctions.[53] Nevertheless, the court defined its "identical standard" of scienter to encompass *Lanza*'s reckless disregard for truth,[54] and in determining that Schuman's conduct was not reckless, the court seemed to be balancing the equities.[55] But-

49. Promptly after disclosing the estimate to McCallum, Schuman reported the projection to the Wall Street Journal and to other financial analysts. A press release was issued the following day. *Id.* at 1238.

50. *Id.* at 1243 n.4. The court followed *Hochfelder* in rejecting the SEC's effect-oriented approach to investor protection. *Id.* at 1244. *See* text accompanying note 34 *supra.*

51. *Id.* at 1240-41.

52. *See* notes 18-29 *supra* and accompanying text.

53. *Id.; see* note 37 *supra.*

The SEC is seeking summary reversal of *Bausch & Lomb* based on the authority of SEC v. Universal Major Industries Corp., 546 F.2d 1044 (2d Cir. 1976), which held that *Hochfelder* does not preclude continued use of a negligence standard in SEC injunctive actions to prevent aiding and abetting violations of § 5 of the 1933 Act. SEC REG. & L. REP. (BNA) No. 385, at A-13 (Jan. 12, 1977). The SEC apparently is urging that negligence should be the standard of care applied uniformly in all SEC injunctive actions, without regard to a more particularized standard of care that might be suggested by the language of the statutory provision allegedly violated. *See id.* at A-14. Despite policy distinctions between SEC injunctive actions and private damage actions, the language of section 10(b) cannot be ignored. *See* note 75 and text accompanying notes 74 & 75 *infra.*

54. 420 F. Supp. at 1242-43 n.4. For a recent case holding that reckless misconduct suffices to establish civil liability under section 10(b) and rule 10b-5, see McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976). The *McLean* court observed that nothing in *Hochfelder* indicated intent to make section 10(b) narrower than common law fraud concepts, which impose liability for recklessness.

55. The court cited a portion of Schuman's testimony as evidence of his conscientious caution in dealing with the analysts and his remorse over the inadvertent disclosure. Particularly significant to the court was the contrast between Schuman's isolated, uncharacteristic disclosure and the continuous and "intentional favoritism" practiced in *Lum's.* The court emphasized its concern for Schuman's dilemma when faced with an immediate need to correct a false rumor, noted his promptness in making the leaked projection public, and concluded that his behavior clearly lacked intent, or recklessness verging on intent, to deceive, manipulate, or defraud. 420 F. Supp. at 1241-44 nn.3&4. *See also* note 25 *supra.*

tressing its conclusion that no violation had occurred, the court also noted the SEC's failure to show that future leaks were likely to occur.[56] Finally, the court chided the SEC for its attempt to use the extraordinary remedy of an injunction, instead of more appropriate administrative regulations, to define the permissible scope of a corporate officer's communications with securities analysts.[57]

In *World Radio Mission,* the SEC sought a preliminary injunction[58] to prevent a religious organization[59] and its leader from violating section 17(a)[60] of the Securities Act of 1933 and section 10(b) and rule 10b-5.[61] The SEC alleged that defendants, when selling debt securities,[62] violated these antifraud provisions by failing to disclose the planned deficit financial condition[63] of the organization and by falsely stating that incoming revenue[64] was adequate to meet regular interest payments and to repay principal. Defendants raised as a

56. *See* note 10 *supra.*

57. The absence of official guidance in the area of disclosure to financial analysts had caused the court earlier in its opinion to criticize the SEC's standard disclaimer of relevant statements made by SEC staff and members in their individual capacities. 420 F. Supp. at 1231.

58. Section 20(b) of the Securities Act of 1933 [hereinafter cited as the 1933 Act], 15 U.S.C. § 77t(b) (1970), uses language similar to that in section 21(d) of the 1934 Act, 15 U.S.C.A. § 78u(d) (Supp. 1976), to provide specific statutory authority for the SEC to seek injunctive relief to prevent violations of the 1933 Act.

59. World Radio Mission, Inc., spreads its religious beliefs worldwide through a radio program and by the publication and distribution of printed materials. 544 F.2d 535, 537 (1st Cir. 1976).

60. Section 17(a) of the 1933 Act, 15 U.S.C. § 77q(a) (1970), provides:

> It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (3) to engage in any transaction, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

61. *See* notes 3 & 4 *supra.*

62. Defendants offered at least two long-term loan plans with regular interest payments, one of which featured a bonus of one acre of land at defendants' developing religious community. At the time of suit, defendants had raised almost $1,400,000 through these investment plans. 544 F.2d 535, 537.

63. Defendants explained that their rapidly increasing operating deficit during the past three years was necessary only until realization of their potential for substantial revenue raising through means such as their publishing company. *Id.* at 542.

64. Defendants' use of a hypothetical that explained to investors the substantial profit potential of their publishing company seemed to imply, albeit incorrectly, that the publishing company was generating a substantial amount of the "revenue" being used to meet current interest obligations. Most of the incoming "revenue" described by defendants actually was derived from new loans. *Id.* at 540 & n.9.

defense their lack of deceptive intent; the SEC asserted that the nature of relief sought made intent immaterial.[65] The First Circuit rejected the defense and granted a preliminary injunction.[66] Suggesting that the facts might have supported a finding of intent to deceive,[67] the court nevertheless broadly asserted that the defendant's state of mind is irrelevant in an SEC injunctive action seeking to prevent future conduct "objectively within the congressional definition of injurious to the public."[68] Citing the dual culpability standards applied by the Second Circuit, the court reasoned that the overriding purpose of protecting the public justified rejecting a scienter requirement in SEC injunctive actions. The court avoided a direct confrontation with the specific language of section 10(b) by noting that the instant action also was founded on section 17(a) of the 1933 Act,[69] which does not require scienter.[70] Nevertheless, the court expressed doubt that Congress intended the specific wording of section 10(b) to preclude use of the specially created SEC injunctive power to protect the public against careless or reckless conduct threatening the same injury that would result from intentional schemes.[71] The court buttressed its effect-oriented analysis by noting that defendants intended to continue practices found deceptive by the SEC and the district court[72] and concluded that a balancing

65. The court observed that the SEC's decision not to allege scienter may have been motivated by deference to the religious organization and might have been "over-generous" if it had been a factual concession. *Id.* at 540.

66. The District Court of New Hampshire found that the SEC had made a prima facie showing of an antifraud violation and of the likelihood of future violations but denied a preliminary injunction based on its balancing of the equities. *Id.* at 537. The First Circuit found a different balance to be appropriate. *See* note 73 *infra* and accompanying text.

67. The court defined intent to deceive as "intent to say something, that is expected to be relied on, that is not believed to be true, or, if strictly true, is hoped will be understood in an untruthful sense." The court suggested that this definition probably could encompass defendant's use of the hypothetical conceruing revenue from their publishing company. *See* note 64 *supra.* 544 F.2d at 540 & n.9.

68. As described in the text accompanying notes 69-71 *infra,* the court did not squarely reconcile its broad statement with the congressional parameters of the injuries encompassed by section 10(b), as expressed in the specific language and legislative history of the section. *See* notes 30-31 *supra* and accompanying text.

69. *See* note 60 *supra.*

70. The court observed that the language of section 17(a) was virtually identical to that of rule 10b-5, which *Hochfelder* conceded arguably made intent irrelevant if read in isolation. 544 F.2d at 541 n.10; *see* note 32 *supra. But cf.* Vacca v. Intra Management Corp., 415 F. Supp. 248, 251 (E.D. Penn. 1976) (In a private action, liability under section 17(a) without a finding of scienter is as inappropriate as it is under section 10(b).).

71. 544 F.2d at 541 n.10.

72. *Id.* at 541. The implication from this observation is that even if defendants' past conduct did not constitute a violation, defendants' demonstrated intent to continue that conduct, despite SEC warnings, would support a finding that future violations are likely to occur. *See* text accompanying note 85 *infra.*

of the equities justified granting the preliminary injunction. Observing that all claims might be satisfied in the event of defendants' financial collapse and liquidation, the court nevertheless deemed a preventive remedy necessary because the interest payments made by defendants constituted an essential source of current income to the investors.[73]

IV. COMMENT

Although *World Radio Mission* did not reconcile clearly its overall policy approach with *Hochfelder*'s particularized, definitional approach,[74] the First Circuit's willingness to temper *Hochfelder*'s specific statutory requirement of scienter by continued recognition of broader policy distinctions between SEC injunctive actions and private damage actions provides a significant challenge to the *Bausch & Lomb* holding. *Hochfelder*'s carefully supported interpretation of the language and legislative history of section 10(b) makes it difficult to contend that the SEC should be able to establish a section 10(b) violation without some showing of scienter.[75] The First Circuit's recognition of this difficulty is indicated by its ultimate reliance on the language of section 17(a) rather than on its broad assertion of the irrelevancy of the defendant's state of mind in SEC injunctive actions. Nevertheless, *Hochfelder* hardly compels the *Bausch & Lomb* court's conclusion that an "identical standard"[76] must be applied in both SEC and private actions. The Supreme Court's express reservation of whether to extend *Hochfelder* to injunctive actions, coupled with its recent decisions limiting the availability of private section 10(b) actions,[77] suggests a possible willingness by the Court to approach the scienter issue differently

73. Promising "interest payments like clockwork," defendants had solicited funds from investors who sought a source of current income. The delay and uncertainty involved in recovery of their investment through potential liquidation would make such procedure inadequate for these investors. 544 F.2d at 542 n.12.

74. *See* text accompanying notes 67-70 *supra*.

75. *See* notes 31 & 36 *supra* and text accompanying note 36 *supra*.

Two commentators strongly contend that *Hochfelder* compels application of the same standard of culpability in section 10(b) actions, regardless of the plaintiff's identity. They assert that *Hochfelder* deserves broad application because of the Supreme Court's reliance on statutory language and legislative history despite the availability of several narrower grounds for its decision. They view *Capital Gains* as a completely inadequate basis to distinguish SEC actions from private actions in the context of section 10(b). Berner & Franklin, *Scienter and Securities and Exchange Commission Rule 10b-5 Injunctive Actions: a Reappraisal in Light of Hochfelder*, 51 N.Y.U.L. REV. 769 (1976).

76. *See* text accompanying note 50 *supra*.

77. *See* note 39 *supra* and accompanying text.

in SEC actions. A more lenient approach in finding scienter in SEC injunctive actions could be justified by the policy considerations[78] previously used to justify a negligence standard in SEC actions. If a more lenient approach is taken with respect to the standard in SEC actions, courts should be mindful that an SEC injunction is more than a "mild prophylactic,"[79] and should include the practical effect on the defendant as one of the factors weighed in the court's exercise of its discretion.[80]

The disagreement between the instant decisions over the continued viability of policy distinctions seems based partially on differences in the factual situations before the courts. The *Bausch & Lomb* holding was influenced by the court's sympathy for a defendant faced with a difficult situation[81] and by its desire to force the SEC to adopt rules to provide meaningful guidance with respect to the permissible scope of corporate communications with investment analysts.[82] Distinguishing Schuman's isolated slip from the repeated disclosures in *Lum's,* the *Bausch & Lomb* court seemed convinced that an injunction was proper in *Lum's,* although it did not explain adequately how such a result, justified originally under a negligence standard, fit into the instant court's uniform approach.[83] In contrast, the First Circuit in *World Radio Mission,* particularly sensitive to the investor's need for a reliable source of current income,[84] urged a dual standard in an effort to preserve the flexibility necessary to effectuate the preventive function of SEC injunctive actions. As *Lum's* and *World Radio Mission* illustrate, circumstances exist in which courts, even without designating the challenged conduct as recklessness bordering on intent to deceive, nevertheless find that continuation or repetition of such conduct poses a sufficiently severe threat to public investors that it should be enjoined. Demanding that the identical standard of culpability be applied regardless of whether the suit is brought by the SEC or a private litigant will

78. *E.g.,* the injunction's preventive, not punitive, purpose; the protection of public interests, not just the reconciliation of competing private interests; and the involvement of judicial discretion in injunctive actions. *See* note 25 *supra* and text accompanying notes 16, 21, & 25 *supra.*

79. SEC v. Capital Gains Research Bureau, 375 U.S. 180, 192-93 (1963) (preliminary injunction against investment adviser properly characterized as "mild prophylactic"). *See* text accompanying notes 16 & 21 *supra.*

80. *See* note 25 *supra.*

81. *See* note 55 *supra.*

82. *See* note 57 *supra* and accompanying text.

83. 420 F. Supp. at 1243 n.4.

84. *See* note 73 *supra* and accompanying text.

either circumscribe the SEC's effectiveness in preventing such conduct or will encourage development of a liberal standard of recklessness that may impose monetary damages in circumstances not contemplated by *Hochfelder*.

Even under a scienter requirement, the SEC still may be able to obtain injunctive relief upon a showing of past negligent conduct if it also can show that a warning would be insufficient to terminate such negligence. Continuation of the same conduct after being warned of its ill effect might constitute a type of recklessness that would satisfy the scienter requirement. Since SEC injunctive relief does not require a past violation, but only the reasonable likelihood of a future violation, the negligent conduct, coupled with the defendant's unwillingness to take affirmative steps to avoid recurrence of such conduct, is evidence from which a reasonable likelihood of future violations may be inferred.[85] The distinction between past conduct and future violations may aid the SEC in obtaining the early termination of a developing deceptive or unfair practice, but it may create confusing precedent. Unless explicit, the opinions in such cases may imply that the past conduct was a violation. Subsequent courts deciding private damage actions based on similar conduct are likely to find the "identical standard" rationale difficult to apply.

The better approach seems to be that taken by the Second Circuit before *Hochfelder* and by the proposed Federal Securities Code—recognition that the protection of the public against deceptive practices involving securities best can be served by affording the SEC flexible power to seek injunctions without proving scienter and that the private interest in avoiding unwarranted injunctions can be protected adequately by the required showing of appropriateness of injunctive relief and ultimately by judicial discretion. *World Radio Mission* notwithstanding, it remains uncertain whether, absent congressional action, the SEC will be able to obtain injunctive relief under section 10(b) and rule 10b-5 without some showing of scienter, at least with respect to the future conduct contemplated. Until Congress acts, the courts should preserve as much flexibility and discretion in SEC injunctive actions as is consistent with the

85. *See* SEC General Counsel's Memorandum Regarding Ernst & Ernst v. Hochfelder, SEC. REG. & L. REP. (BNA) No. 354, at F-1 to -2 (May 26, 1976); note 72 *supra* and accompanying text.

Hochfelder rationale by using in such actions a case-by-case analysis of the scienter element in lieu of the *Baush & Lomb* "identical standard."

FRANCES LOUISE ADAMS

Torts — State Liability — Absent Specially Created Statutory Immunity the State is To Be Treated As a Private Litigant Liable to Those Foreseeably Injured by Its Negligent Acts or Omissions

I. FACTS AND HOLDING

Plaintiffs[1] brought an action for damages against the State of Alaska contending that state inspectors,[2] after undertaking an inspection of a hotel[3] and discovering fire hazards,[4] failed to exercise reasonable care to alleviate the dangerous conditions.[5] The state argued that, as a public entity,[6] it owed a duty only to the public

1. Plaintiffs included some of those injured and the personal representatives of five persons who died when the Gold Rush Hotel, located near Anchorage, burned to the ground.

2. Although the state fire marshal's office had a general policy of deferring to local fire inspectors when such authorities existed, three state officials performed the inspection, exercising state jurisdiction over the hotel.

3. No Alaska statute specifically sets forth a regular procedure for fire inspection. ALASKA STAT. § 18.70.050 (1974), however, provides:

> The Department of Public Safety may enter any building subject to regulation . . . of this chapter during reasonable hours for the sole purpose of inspecting the property or abating a fire hazard.

4. The inspectors discovered two potential fire hazards at the Gold Rush Hotel. Construction in progress on the third floor of the hotel had exposed wooden framing and building materials. Additionally, the fire alarm system, despite a functional appearance, was inoperative. Immediately after the inspection, the assistant state fire marshal wired his superior that the hotel presented an "extreme life hazard."

5. Although the state inspectors failed to require abatement of the discovered hazards, several statutes outline enforcement measures that could have been taken upon discovery of the fire hazards. ALASKA STAT. § 18.70.070 (1974) allows the Department of Public Safety to require a building owner to remedy existing violations. Under powers granted by ALASKA STAT. § 18.70.080 (1974), the Department of Public Safety adopted 13 AAC 55.060, providing that when an inspector finds certain named hazards, he shall post at the entrance to the premises a notice to read: "DO NOT ENTER, UNSAFE TO OCCUPY. DEPARTMENT OF PUBLIC SAFETY, DIVISION OF FIRE PREVENTION."

In practice, upon discovery of a fire hazard the state normally would serve two notices of deficiency, and then, if warranted, obtain a court order to alleviate the hazard.

6. The state's contention is often referred to as the public duty doctrine or the "duty to all, duty to no one" doctrine. The basic theory supporting this doctrine is that because

generally, not to any individual. The trial court,[7] conceding that the state's failure to remedy known fire hazards was negligent, nevertheless held that the state could not be liable to specific plaintiffs and granted summary judgment for the state. On appeal, the Supreme Court of Alaska *held,* reversed and remanded. Absent specially created statutory immunity, the state is treated as a private litigant and is liable to persons foreseeably injured by its negligent acts or omissions. *Adams v. State,* 555 P.2d 235 (Alaska 1976).

II. LEGAL BACKGROUND

At common law the state enjoyed general immunity from liability for its negligent torts. Derived from the medieval maxim "the King can do no wrong,"[8] the doctrine of sovereign immunity became engrafted on American law[9] in 1821 when Chief Justice Marshall declared that the government could not be sued without its consent.[10] Justice Holmes later affirmed the doctrine by reasoning that there should be no right of action against the authorities that make the rule upon which the right depends.[11] Current defenses of governmental immunity cite policy considerations more relevant to the need of modern governments to deliver social services to large groups of people. Proponents of the immunity doctrine argue that the state undertakes to provide certain services solely for reasons of social utility, and should not be deterred from supplying these services by potential liability.[12] Additionally, advocates contend that governmental immunity is necessary to promote the efficient functioning of government, which would be severely hampered by limitless liability and endless litigation if a private citizen were given the

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the state owes a duty only to the public generally, it does not owe an actionable duty to any one individual.

7. The trial court was the Superior Court, Third Judicial District, Anchorage.

8. W. PROSSER, THE LAW OF TORTS § 131 (4th ed. 1971) [hereinafter cited as PROSSER]; Borchard, *Governmental Responsibility in Tort, VI,* 36 YALE L.J. 1, 17-38 (1926); James, *Tort Liability of Governmental Units and Their Officers,* 22 U. CHI. L. REV. 610, 611-12 (1955).

9. *See* PROSSER, *supra* note 8, at § 131; James, *supra* note 8, at 612 & n.11. This development is curious when one considers that the United States was founded on the precept that the King could do no right. *See* Baer, *Suing Uncle Sam in Tort,* 26 N.C.L. REV. 119 (1948).

10. Cohens v. Virginia, 19 U.S. (6 Wheat.) 264 (1821).

11. Kawananakoa v. Polybank, 205 U.S. 349, 353 (1907). For a critical analysis of Holmes' reasoning, see Borchard, *Governmental Responsibility in Tort, V,* 36 YALE L.J. 757 (1927).

12. *See* Smith, *Municipal Tort Liability,* 48 MICH. L. REV. 48, 50-51 (1949); Note, *Separation of Powers and the Discretionary Function Exception: Political Question in Tort Litigation Against the Government,* 56 IOWA L. REV. 930, 932 n.6 (1971).

right to sue the state.[13]

Guided by these policy considerations, both legislatures and courts have endorsed the doctrine of state immunity. Because each body implements immunity by a different method, it is possible for both the courts and the legislature in the same state to create separate guidelines for immunity. Almost half of the states control immunity by statutes indicating which state activities are immune from liability.[14] Statutes modeled after the Federal Tort Claims Act of 1946[15] retain some state immunity by enumerating several exceptions to a general waiver of immunity from individual claims. The most frequently litigated form of immunity is an exception providing that the state will not be liable for the consequences of its "discretionary" acts.[16] In determining which state acts are "discretionary," courts following the principal case, *Dalehite v. United States*,[17] have placed the greatest emphasis on the language set forth in the *Dalehite* dictum, which interprets "discretionary" acts to include only those basic policy decisions made at the planning level, while those acts performed at the ministerial or operational level are actionable.[18] Nonetheless, the discretionary function

13. United States v. Lee, 106 U.S. 196, 206 (1882); *see* Block, *Suits Against Government Officers and the Sovereign Immunity Doctrine*, 59 HARV. L. REV. 1060, 1061 (1946); James, *supra* note 8, at 614; Comment, *An Analysis of the Theories Advanced for the Continuation of Municipal Tort Immunity*, 2 CUM.-SAM. L. REV. 437, 443 (1971).

14. Harley & Wasinger, *Governmental Immunity: Despotic Mantle or Creature of Necessity*, 16 WASHBURN L.J. 12, 33 (1976).

The statutes vary greatly and are capable only of broad categorization. Some statutes are modeled after the Federal Tort Claims Act of 1946, ch. 753, § 402, 60 Stat. 842 (now codified at 28 U.S.C.A. §§ 2671-80 (Supp. 1976)). *See, e.g.*, IDAHO CODE § 6-901 to -928 (Cum. Supp. 1976). Other statutes provide merely that the state shall be liable in the same situations in which a private individual would be liable, but impose an upward limit on recovery. *See, e.g.*, N.C. GEN. STAT. § 143-291 (Cum. Supp. 1975). Other codes contain lists of specific state activities actionable or immune, and a complex system of administration. *See, e.g.*, CAL. GOV'T CODE §§ 810-996.6 (West 1966 & Supp. 1977).

15. Federal Tort Claims Act of 1946, ch. 753, § 402, 60 Stat. 842 (now codified at 28 U.S.C.A. §§ 2671-80 (Supp. 1976)). Ten states have statutes modeled more or less after the Federal Tort Claims Act, including ALASKA STAT. §§ 09.50.250-300 (1973).

16. Typical of this discretionary function exception is ALASKA STAT. § 09.50.250 (1973), which provides in part:

> A person or corporation having a . . . tort claim against the state may bring an action against the state in superior court . . . . However, no action may be brought under this section if the claim
>
> (1) . . . is an action for tort, and based upon the exercise or performance or the failure to exercise or perform a discretionary function or duty on the part of a state agency or employee of the state, whether or not the discretion involved is abused . . . .

17. 346 U.S. 15 (1953).

18. *See* Reynolds, *The Discretionary Function Exception of the Federal Tort Claims Act*, 57 GEO. L.J. 81, 103-107 (1968). These cases follow the "operational-planning" test suggested by the *Dalehite* dictum.

standard remains much criticized for its vagueness and susceptibility to inconsistent interpretation.[19]

Courts have employed two distinct methods to provide the state immunity from liability for its negligent torts. Some courts, imitating the legislatures, have categorized state activities as either "governmental" or "proprietary."[20] "Governmental" functions, those usually performed by governmental units,[21] are sheltered by immunity. "Proprietary" functions, those normally provided by private persons,[22] are actionable. This inadequate distinction predictably results in confusion and inconsistent holdings.[23]

More recently, courts have employed a duty analysis to shield the state from liability. By finding that the state owes a duty only to the general public and not to any individual, courts have protected the state from liability for acts which otherwise clearly would be actionable.[24] Courts have abrogated this public duty doctrine by converting selected government duties, traditionally owed only to the public at large, into duties to act for the benefit of particular individuals. In three specific factual situations courts have held that the state's general public duty also encompasses a duty to private

19. "The discretionary function provision . . . is an ill-conceived and poorly-thought-out attempt to solve some of the most sensitive problems concerning the proper limits of governmental liability." 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 29.15, at 1661-62 (1956); *see* State v. Abbott, 498 P.2d 712 (Alaska 1972); Clark, *Discretionary Function and Official Immunity: Judicial Forays into Sanctuaries from Tort Liability,* 16 A.F.L. REV. 33, 40-43 (1974); Reynolds, *supra* note 18, at 81.

For a list of examples illustrating the distinctions between "discretionary" and "operational" activities, see United Air Lines, Inc. v. Wiener, 335 F.2d 379, 393 (9th Cir.), *cert. dismissed,* 379 U.S. 951 (1964).

20. This distinction was first made by a New York court in Bailey v. Mayor of New York, 3 Hill (Sup. Ct.) 531 (1842).

21. Certain functions and services which only the government can perform adequately are labelled "governmental," and generally are immune from liability. Typical of these functions are torts of police officers, operation of public schools, or the administration of quarantines. PROSSER, *supra* note 8, at § 131.

22. Functions provided by the government which might as well be performed hy a private corporation are characterized as "proprietary," and normally are not sheltered from liability. Such functions include the supplying of gas, water, and electricity, or operating an airport. *Id.*; *see* Greenhill & Murto, *Governmental Immunity,* 49 TEX. L. REV. 462 (1971).

23. Critics of this distinction have noted that the rules established by the courts to distinguish between "governmental" and "proprietary" functions are "as logical as those governing French irregular verbs." Weeks v. City of Newark, 62 N.J. Super. 166, 162 A.2d 314 (1960), *aff'd per curiam,* 34 N.J. 250, 168 A.2d 11 (1961); *see* Indian Towing Co. v. United States, 350 U.S. 61 (1955); Seasongood, *Municipal Corporations: Objections to the Governmental or Proprietary Test,* 22 VA. L. REV. 910 (1936).

24. *See* Duran v. City of Tucson, 20 Ariz. App. 22, 509 P.2d 1059 (1973); Modlin v. City of Miami Beach, 201 So. 2d 70 (Fla. 1967); Hoffert v. Owatonna Inn Towne Motel, 293 Minn. 220, 199 N.W.2d 158 (1972).

individuals and have declared the state liable for its negligence. First, courts have found that the state assumes a duty to an individual with whom it enters into a "special relationship."[25] Adopting this rationale, the court in *Schuster v. City of New York*[26] decided that the state could be liable for negligent failure to protect a citizen who requested police protection after giving information about a notorious criminal.[27] Secondly, the state owes a duty to a special class of individuals when it has direct control of the instrumentality producing harm to its citizens. Thus, in cases involving rescue operations[28] or highway maintenance,[29] the state is liable to those persons injured by its negligence since these functions are exclusively within state control. In *Lee v. State*,[30] the state was held liable for a state trooper's negligent shooting of a young girl while undertaking to rescue her from the jaws of a lion. In *State v. Phillips*,[31] the state's negligent failure to alleviate dangerous highway conditions of which it had notice resulted in its liability for a subsequent accident. Finally, the state will be held liable when statutes create a duty to provide a special benefit for a particular class of individuals.[32] In *Campbell v. City of Bellevue*,[33] statutes required inspectors discovering hazardous underwater electrical wiring to sever the connections until the deficiency could be corrected. Negligent failure to obey the statute resulted in government liability for a subsequent electrocution.

Although the courts have eroded substantially the traditional doctrine of state immunity, a duty analysis still remains a potential means for any court to circumvent even liability imposed by legislative enactment. Thus courts have been able to shelter the state

25. *See* 59 COLUM. L. REV. 487, 492-94 (1959).

26. 5 N.Y.2d 75, 154 N.E.2d 534, 180 N.Y.S.2d 265 (1958).

27. While visiting New York City, Arnold Schuster recognized the infamous Willie "The Actor" Sutton and informed the police. Schuster's role in the apprehension of Sutton received wide publicity. Almost immediately Schuster and his family received violent threats hy mail and over the telephone. Schuster notified the police of the threats and requested protection. The police supplied inadequate protection, and Schuster was shot to death on a public street.

28. *See* Lee v. State, 490 P.2d 1206 (Alaska 1971); City of Fairbanks v. Schaible, 375 P.2d 201 (Alaska 1962).

29. *See* State v. I'Anson, 529 P.2d 188 (Alaska 1974); State v. Abbott, 498 P.2d 712 (Alaska 1972); State v. Phillips, 470 P.2d 266 (Alaska 1970).

30. 490 P.2d 1206 (Alaska 1971).

31. 470 P.2d 266 (Alaska 1970).

32. *See* Griffin v. United States, 500 F.2d 1059 (3d Cir. 1974); Runkel v. City of New York, 282 App. Div. 173, 123 N.Y.S.2d 485 (1953), *aff'd mem. sub. nom.*, Runkel v. Homelsky, 3 N.Y.2d 857, 145 N.Y.2d 23, 166 N.Y.S.2d 307 (1957).

33. 85 Wash. 2d 1, 530 P.2d 234 (1975).

from liability either in the absence of or contrary to statutory authority.

III. The Instant Opinion

The instant court first considered whether the state had assumed a duty arising from its inspection of the hotel. Expressly refusing to determine whether safety codes imposed a statutory duty to abate discovered dangerous conditions,[34] the court nevertheless found that by undertaking the inspection the state had assumed a common law duty to take further reasonable action after discovering any hazards.[35]

The court next examined whether the state owed this newly-defined duty to the plaintiffs. Establishing that the purpose of the inspection was to locate and remedy any hazards endangering users of the hotel, the court found plaintiffs to be members of that class of persons and the intended beneficiaries of the state's service. Noting that a private party defendant clearly would owe a duty to plaintiffs,[36] the court rejected the state's contention that it owed a duty, not to plaintiffs, but only to the general public. The court recognized the state's assertion as a claim of sovereign immunity, a matter plainly within the province of the legislature. Announcing that a duty to a limited class should not be harder to establish simply because the defendant is the state, the court concluded that, absent statutory immunity, the state is to be treated as a private litigant.

Citing previous judicial abrogations of state immunity, the court acknowledged that immunity had been abolished when the state assumed a duty to a limited class whereby a "special relationship" developed,[37] when a statute existed for the benefit of a particular group,[38] or when the state controlled the instrumentality producing the harm.[39] Reasoning that the state could cause injury as easily by failure to follow through after an inspection, the court

34. An annotation to Alaska Stat. § 18.70.050 (1974) cites an unreported case noting that the legislature did not intend to impose a duty on state officials in connection with enforcement of the regulations dealing with fire protection.

35. The court declined to decide whether the state should be charged with a duty to discover hazards absent the undertaking of an inspection. 555 P.2d at 240.

36. *See* Hill v. United States Fidelity & Guar. Co., 428 F.2d 112 (5th Cir. 1970); Johnson v. Aetna Cas. & Sur. Co., 339 F. Supp. 1178, *modified*, 348 F. Supp. 627 (M.D. Fla. 1972); Nelson v. Union Wire Rope Corp., 31 Ill. 2d 69, 199 N.E.2d 769 (1964).

37. *See* notes 25-27 *supra* and accompanying text.

38. *See* notes 32 & 33 *supra* and accompanying text.

39. *See* notes 28-31 *supra* and accompanying text.

extended its duty analysis beyond the three recognized factual situations.

The court, finding that the state enjoyed no judicial immunity from suit, next considered whether the Alaska statute granting immunity in only certain specified situations[40] sheltered the state from plaintiff's claims. Relying on the statutory policy of insulating the governmental process from extensive interference, the court observed that the legislature intended to immunize only the state's "basic policy decisions."[41] Recognizing that the Alaska legislature had expressly adopted a policy of risk-spreading to prevent one individual from bearing the total burden of the state's negligence, the court ruled that this policy outweighed the risk that liability would interfere with the state's capacity to operate.

IV. COMMENT

The instant decision makes significant progress toward eradicating some of the inconsistencies and inequities currently plaguing jurisdictions in which both the legislature and the courts have developed guidelines for state liability and immunity. Legislative enactments have determined which state activities should remain protected despite a general waiver of immunity. The courts also have sheltered the state from liability by declaring that the state owed a duty only to the public, not to private litigants. Both branches basically have sought to balance an interest in governmental efficiency against fairness to individuals injured by the government's negligence. This two-pronged implementation of the same policy considerations has produced several undesirable results. First, by holding that only in certain defined situations did the state's general public duty include an actionable duty to a limited class, the courts in essence have created immunity in areas not necessarily intended by the legislature. Secondly, an injured party seeking to recover against the state faced a nearly insurmountable burden of proving that the state owed him a special duty separate from a general public duty.

In holding that, absent statutory immunity, the state is to be liable for its negligent torts as a private litigant, the Alaska court abolished the special categories of relationships that the courts pre-

40. *See* note 16 *supra*. In addition to the "discretionary function" exception, the state is immune from liability for such acts as imposing a quarantine, assault and battery, false imprisonment, malicious prosecution, libel, slander, misrepresentation, or interference with contract rights. ALASKA STAT. § 09.50.250 (1973).

41. *See* note 18 *supra* and accompanying text.

viously had to find before the state owed an actionable duty to a limited class of individuals. Because the immunity statutes and the court's doctrine of "duty to all, duty to no one" served the same policy interests, the instant court's decision eliminated a duplication of effort that could only cause confusion. Appropriately, the burden of deciding which state activities deserve immunity now rests solely with the legislature, which is far better equipped than the judiciary to decide which governmental services must carry the risk of uncompensated injury to private individuals. Courts lack the expertise to balance the workable guidelines for state liability or immunity. Through its control of financial resources the legislature is able to integrate potential tort liability into planned schemes for the delivery of social services, supplying the orderliness and predictability demanded by government planners. Finally, the total responsibility placed on the legislature should prompt the enactment of more succinctly-worded guidelines designed to eliminate the judicial bewilderment encountered in deciphering terms like "discretionary," "ministerial," or "operational."[42]

The instant decision endorses the equitable notion that when there is negligence, liability is the rule, immunity the exception. Ignoring the fairness of spreading the risk of state liability over society as a whole, defenders of state immunity point out that increased state liability for negligent inspection will result in a massive drain on state funds, burdensome amounts of litigation, and the reluctance of inspectors to perform their tasks. The legislature is in a perfect position to address these potential problems. Although several studies have shown that no severe financial problems result from increased governmental tort liability,[43] the legislature clearly has the power to place limits on financial recovery by any individual.[44] Additionally, the legislature can purchase insurance to protect selected state agencies.[45] To offset potential burdens on the court system, the legislature can construct a suitable procedural framework for the administration and adjudication of claims against the state. Indeed, several states already have created tribunals to hear such claims.[46] If the legislature discovers that increased liability for

42. Reynolds, *supra* note 18, at 113-32, summarizes proposals to clarify statutory language.

43. *See* David, *Tort Liability of Local Government: Alternatives to Immunity from Liability or Suit,* 6 U.C.L.A. L. REV. 1, 8-14 (1959).

44. *See, e.g.,* IND. CODE ANN. § 34-4-16.5 (Cum. Supp. 1976).

45. *See* Note, *An Insurance Program to Effectuate Waiver of Sovereign Tort Immunity,* 26 U. FLA. L. REV. 89 (1973).

46. *See, e.g.,* N.Y. CT. CL. ACT §§ 1-30 (McKinney 1963 & Cum. Supp. 1976-77).

failure to follow through with an inspection has deterred the undertaking of inspections or, more likely, has resulted in litigation over even the most minute violations, it can adjust the safety codes to provide more specific duties or can simply eliminate liability for negligent inspection. Given the legislature's potential to devise and administer uniform guidelines for state liability and immunity, the instant court took a significant step not only toward ending confusion and promoting uniformity, but also toward reaching the most effective balancing of interests in the problem of state immunity.

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