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Recent Cases

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RECENT CASES

Banks and Banking—Usury—National Bank Reserving Interest in Advance on Installment Loans Yielding an Effective Rate of Return in Excess of Statutory Limit Violates Section 85 of National Bank Act if Same Loan Made by State Lender Would Be Usurious

I. Facts and Holding

Plaintiff, a national bank operating in Arkansas pursuant to the National Bank Act,[1] sought a money judgment for principal and interest due it as payee on two notes executed by defendant, a natural person. The notes evidenced two installment loans on which the bank had charged eight percent interest in advance,[2] by discounting one note and by adding interest to the face of the other note.[3] Refusing to honor the notes, defendant contended that the advance interest charges, which raised the effective yields on both notes[4] above the Arkansas ten percent annual limit,[5] were usurious

1. 12 U.S.C. § 21 *et seq.* (1970).

2. One note evidenced an installment loan of $11,000 payable in twelve equal monthly installments, from which the bank had discounted eight percent annual interest. The other note evidenced a $2,000 loan payable in thirty-six equal monthly installments to which the bank had added eight percent interest in advance. Defendant executed both notes on January 11, 1974 and renounced them as usurious on January 15, 1974 without having made any payments.

3. "Discounting" and "adding-on" are distinguishable in that the face amount of a "discounted" note represents the amount on which the interest is based, although the borrower actually receives the face amount less that interest (net principal), whereas the face amount of an "added-on" note represents the amount on which the interest is based plus the interest, although the borrower actually receives only the amount on which the interest was based (face amount less interest, or net principal). The effects of "discounting" and "adding-on" are similar (the effective yield of "adding-on" being only slightly less than the effective yield of "discounting"). For purposes of this comment, the term "discounting" will encompass "adding-on."

4. The effective yield of the twelve month loan was 16.05% per annum; the effective yield of the thirty-six month loan was 15.75% per annum.

5. Ark. Stat. Ann. § 68-602 (1957) provides in part:

> *Maximum rate of interest by contract.*—The parties to any contract, whether the same be under seal or not, may agree in writing for the payment of interest not exceeding ten per centum . . . per annum on money due or to become due.

Ark. Stat. Ann. § 68-603 provides:

> *Usurious interest prohibited.*—No person or corporation shall, directly or indirectly, take or receive in money, goods, things in action, or any other valuable thing, any greater sum or value for the loan or forbearance of money or goods, things in action, or any other valuable thing, than is in section [68-602] of this act prescribed.

because section 85 of the National Bank Act permits national banks to charge only as much interest as the most favored lenders operating under state law,[6] and Arkansas would treat these installment loans as usurious if made by its most favored state lender.[7] Plaintiff asserted that only the state statute setting the ten percent maximum rate, and not the state case law construing the rate's proper calculation to encompass effective yield, applies to national banks. The District Court, upholding defendant's contention, held that both notes were usurious and thus void with respect to interest but not principal.[8] The Eighth Circuit Court of Appeals, *held*, affirmed. Where a national bank reserves interest in advance on installment loans, calculated at a numerical rate not in excess of the statutory usury limits but yielding an effective rate of return in excess of the state limit, and if a similar loan made by a state lender would be usurious, the interest charged is beyond the "rate allowed by the laws of the State" in violation of the National Bank Act, 12 U.S.C. § 85. *First National Bank v. Nowlin*, 509 F.2d 872 (8th Cir. 1975).

II. BACKGROUND

Although most states permit the deduction of interest in advance at the highest legal rate,[9] many states restrict the practice to

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6. 12 U.S.C. §85 (1970) derived from section 30 of the National Bank Act of 1864 ch. 106, § 30, 13 Stat. 108, and from Revised Statutes § 5197 (1875) without material change, states in pertinent part:

> Any association may take, receive, reserve, and charge on any loan or discount made . . . or other evidences of debt, *interest at the rate allowed by the laws of the State* . . . where the bank is located . . . *and no more*, except that where by the laws of any State a different rate is limited for banks organized under State laws, the rate so limited shall be allowed . . . . (emphasis added)

The section also provides an alternative rate of one percent in excess of the discount rate (or 5% in excess of the discount rate in the case of business or agricultural loans of at least $25,000) on ninety-day commercial paper in effect at the Federal Reserve Bank, if higher than the state rate. The alternative rate was not pertinent to the issues in the instant case. Note that the alternative rate applicable to business or agricultural loans does not go into effect until 1977, unless the state enacts an interest law with similar provisions. 12 U.S.C. § 1831a (P.L. 93-501, § 206 (October 29, 1974)).

7. The Arkansas Supreme Court has construed the state's constitutional limit of ten percent interest per annum as prohibiting an effective or actual yield beyond ten percent annually based on the amount of money the borrower actually receives and the length of time he has actual use of it. Davidson v. Commercial Credit Equip. Corp., 255 Ark. 127, 499 S.W.2d 68 (1973), *construing* ARK. CONST. art. 19, § 13 and ARK. STAT. ANN. §§ 68-602, -603, -608 (1957).

In the instant case the plaintiff-bank conceded that an Arkansas court would hold the loans to defendant usurious if made by a state lender.

8. The District Court denied defendant's counterclaim for forfeiture of principal and return of interest paid under Arkansas law, ARK. CONST. art. 19, § 13, and applied the federal penalty requiring only forfeiture of interest under 12 U.S.C. § 86 (1970).

9. 6 MICHIE ON BANKS AND BANKING § 33, at 282-88 (1952).

short term loans, while a few jurisdictions, including Arkansas, prohibit the practice on all loans[10] because it increases the effective rate beyond the fixed legal rate. Whether a state law restricting loan discounts applies to national banks located within state borders depends on the construction of Section 85 of the National Bank Act, which permits national banks to charge "interest at the rate allowed by the laws of the State . . . and no more."[11] Crucial to the determination of cases decided under this provision has been each court's position on the policy question of whether the Act should place the national bank on parity with state banks or provide it preferential treatment. The borrower has succeeded in proving usury only in cases in which the court has adopted the parity posture. Interpreting section 85 nine years after its 1864 enactment, the Supreme Court in *Tiffany* v. *National Bank*[12] failed to consider the then still recent legislative history and read the Act as designed to protect national banks against state discrimination and intended ultimately to replace state banks by national banks.[13] The Court established the preferred lender doctrine to give national banks a competitive advantage over state banks, holding that a national bank may charge the highest interest rate allowed to the state's most favored lender and is not restricted to the often lower rate governing the state banks.[14] In *Union National Bank* v. *Louisville, New Albany & Chicago Railway Co.*,[15] however, the Court interpreted section 85 in a manner unfavorable to the national bank by accepting the Illinois Supreme Court's interpretation of the state's preferred lender rate and refusing to substitute a construction more favorable to the national bank. The Court held that, by incorporating the state rate in the Act, Congress made the interest rate a matter of federal law, but did not authorize the federal courts to interpret the rate adversely

10. For a thorough discussion of the differences among the states regarding discounting short term notes, long term notes and installment notes, see *Taking or Charging Interest in Advance as Usury*, 57 A.L.R.2d 630, §§ 10a, 10b (1958).

11. 12 U.S.C. § 85 (1970).

12. 85 U.S. (18 Wall.) 409 (1873).

13. *Id.* at 413; *accord*, C. Kreps, Modernizing Banking Regulation, 31 LAW & CONTEMP. PROB. 648, 649-50 (contending that the prohibitive tax imposed on notes issued by state banks was intended to eliminate the profitability of state banking, but that the unforseen rise of deposit banking saved the state banks). *Contra*, Note, 58 IOWA L. REV. 1250 (1973) (criticizing *Tiffany* and contending that a proper reading shows an intent to establish equality between state and national banks).

14. The Court reached its conclusion by construing the word "different" in section 85 (see note 6, *supra*) to mean "higher" and not to mean "higher or lower" so that when a state sets a "different" rate for state banks, that different rate applies to national banks only if it is higher than the rate allowed other lenders; if the different state bank rate is lower, the national bank may follow the higher rate allowed other lenders.

15. 163 U.S. 325 (1896) (interpreting Rev. Stat. § 5197, the predecessor of § 85).

to the state courts.[16] Following the *Union National Bank* rule of accedence to the state court construction, the Court in *Citizens National Bank v. Donnell*[17] held that a national bank that compounds interest in a manner prohibited by state law[18] violates the Act even though the total interest amounts to less than the maximum rate permitted by the state. Nevertheless, when the Court interpreted the provision as applied to state discounting rules in *Evans* v. *National Bank*,[19] it avoided an analogy to *Citizens National Bank* by relying on dicta in a pre-Act case[20] and on common banking practices, ignoring a Georgia statute prohibiting discounts from exceeding an eight percent effective rate. The Court found that a single payment short-term note discounted at the state's maximum eight percent rate, but yielding in excess of eight percent, was not usurious even though the same loan if made by a state lender would be usurious. Moreover, it held that the rate "allowed by the State" means the statutory numerical rate without regard to the state's prescribed method of construing or calculating the rate. Three Justices dissented[21] on the basis of *Citizens National Bank, Union National Bank*[22] and a discerned Congressional intent to place national banks upon a precise equality with state banks.[23] Recently the Sixth Circuit in *Northway Lanes v. Hackley Union National Bank and Trust Co.*[24] extended *Evans* to apply to a long-term installment note, to which interest had been added in advance

16. . . . [T]he true construction of state legislation is a matter of state jurisprudence, and while the right of the national bank springs from the Act of Congress, yet it is only a right to have an *equal administration of the rule established by the state law*. It does not involve a reservation to the national courts of the authority to determine adversely to the state courts what is the rule as to interest prescribed by the state law, but only to see that such rule is *equally enforced* in favor of national banks. (emphasis added)

Id. at 331.

17. 195 U.S. 369 (1904) (interpreting Rev. Stat. § 5197).

18. The Supreme Court subjected the national bank to a Missouri statute prohibiting the compounding of interest more often than once per year.

19. 251 U.S. 108 (1919).

20. Fleckner v. Bank of the U.S., 21 U.S. (8 Wheat.) 338, 353 (1823). *Fleckner* is a federal charter case, in which the Court held that discounting was permitted by the bank's charter, adding in dicta that discounting was widely practiced.

21. The dissent contended that "the laws of the State" means "all applicable provisions of the statutes as interpreted and construed by the decisions of the [state] court of last resort. . . . The section has regard to substance, not merely to form." 251 U.S. at 116, 118.

22. *See* Comment, 29 YALE L.J. 457 (1920) (criticizing the majority for its position inconsistent with prior decisions).

23. 251 U.S. 108, 117-18 (1920). Although the Justices read Congressional intent as desiring national bank parity with state *banks*, they accepted the *Tiffany* doctrine establishing the parity between national banks and state *preferred lenders*.

24. 464 F.2d 855 (6th Cir. 1972).

at the maximum rate.[25] The applicable state statute prohibited discounting at the maximum rate unless the lender submitted to certain restrictions with which the national bank did not comply.[26] The Court held that the national bank was not bound by the state restrictions on discounting because its right to discount arose independently of state laws that govern state lenders.[27] To date, *Evans* represents the only exception to the Court's interpretation that section 85 incorporates the state interest laws as construed and applied by the state court of last resort. Lower courts continue to defer to state restrictions on interest rates in situations other than those involving discounting,[28] and abide by *Evans* in cases concerning discounting of single payment short-term notes, but must select between the *Evans* and *Union National Bank* rationales when confronted with an installment note discounted in a manner prohibited by the state. *Northway's* acceptance of *Evans* as controlling installment note discounts represents the choice that accords a national bank a competitive advantage not only over state banks, but also over the most favored state lender.

III. The Instant Opinion

The instant court regarded *Evans* as inapplicable to discounted installment loans, a type of obligation probably never contemplated by the *Evans* Court in 1919 and distinguishable from discounted single payment short-term loans by their higher effective yield. Installment credit, the court explained, was practically nonexistent at the time of *Evans*[29] and has become widespread only with the recent

25. The note evidenced the total of the amount loaned, $250,000, and the interest for five years at seven percent, $87,000, to constitute a face amount of $337,500, to be paid in forty equal installments. The effect of the advance adding-on of interest and the installment payments raised the actual or effective rate of interest to 13½% per annum.

26. The restrictions were prescribed maximums on the amount of principal and charging costs.

27. 364 F.2d 855, 860-61 (6th Cir. 1972).

28. *See, e.g.*, Partain v. First Nat'l Bank, 336 F. Supp. 65 (M.D. Ala. 1971), *rev'd on other grounds*, 467 F.2d 167 (5th Cir. 1972) (*Tiffany* doctrine cannot he used to permit national bank to evade state laws limiting the amount of principal loaned at certain interest rates).

29. Today's installment note was uncommon at the time of *Evans* and nonexistent at the time of *Fleckner v. Bank of the U.S.*, the case on which the *Evans* court based its decision to permit discounting of short term notes. The instant case renounced *Fleckner*'s discussion about banking practices as irrelevant to a consideration of commercial needs today, 150 years after *Fleckner*. 509 F.2d 872, 878.

The amount of outstanding installment debt was still negligible in 1945, twenty-six years after *Evans*, when it constituted merely 2.5 billion dollars. The total reached 29 billion in 1955, and has recently peaked at 100 billion. D. Caplovitz, *Breakdowns in the Consumer Credit Marketplace*, 26 Bus. Lawyer 795 (1971).

advent of consumer credit. In addition, the court observed that while the discounting of single payment short-term notes, ratified by the Supreme Court in *Evans*, will increase the effective yield only nominally, the discounting of long-term and installment notes may increase the effective yield by a factor of two or more.[30] In view of the increased economic impact on the consumer and the discrimination against state lenders not permitted to discount, the court expressed doubt that the Supreme Court today would extend *Evans* to apply to installment or long-term notes. Having dismissed *Evans* as inapplicable, the instant court then denied the validity of *Northway* for its failure to distinguish between the economic effects of discounting single payment short-term notes and installment paper. Having found no authoritative case law on installment note discounting, the court construed section 85 in light of legislative history[31] and discerned a Congressional intent to give national banks full parity of interest regulation with state banks or with any lender given preference by the state. The preferred lender policy, the court declared, was not intended to be extended to give national banks superiority over all state lenders. In further support of its position on the Act's underlying policy, the court cited *Union National Bank* and *Citizens National Bank*, as well as two recent Supreme Court cases that express a policy of parity, or "competitive equality,"[32] between national banks and preferred state lenders. The court indicated that the only construction of section 85 consistent with this policy requires incorporation of the state's interpretation of its own interest rate and the manner of calculating that rate. The court therefore concluded that when a state interprets its statutory rate to mean effective rate, so as to disallow installment paper discount-

30. The court gives the following example in a footnote. While a $1,000 single payment one-year note discounted at eight percent yields an effective rate of 8.7%, the same note yields 16.05% if principal and interest are repaid in twelve monthly installments. 509 F.2d 872, 878 n.13. For other examples of effective yields on discounted installment paper, see the tables in B. WOFFORD, ANNUAL YIELDS ON INVESTMENTS (Nevada Research Report No. 4, 1965).

31. Citing the Senate debate, CONG. GLOBE, 38th Cong., 1st Sess. 2123-27, 2145 (1864), and a study of the provision's intended meaning, Comment, 58 IOWA L. REV. 1250 (1973). *See* Note, 35 COLUM. L. REV. 416, 425 (1935).

32. First Nat'l Bank v. Dickinson, 396 U.S. 122, 133, 136-37 (1969); First Nat'l Bank v. Walker Bank & Trust Co., 385 U.S. 252, 261 (1966).

Compare the *Dickinson* Court's statement about "penetrating the form of the contracts to the underlying substance of the transaction," 396 U.S. at 137, to the *Evans* dissent's criticism of the majority's failure to look beyond the form of the loan, 251 U.S. 108, 118 (quoted *supra*, note 21). Also, note the *Dickinson* Court's statement that in construing the statutory term "branch" the Court should consider the aspects of the transaction "that might give the [national] bank an advantage in its competition. . . ." 396 U.S. at 136-37. By analogy, the instant court invalidated the loan transaction because it gave an advantage to the national bank.

ing that achieves an effective rate beyond the statutory maximum, the state's interpretation applies to national banks by virtue of 12 U.S.C. § 85.

IV. COMMENT

If the instant case, rather than *Northway*, is to become the accepted rule in the area of discounting, consumers and state lenders will be protected while the national bank-lenders will be burdened only slightly, if at all. National banks located in states that permit state lenders to discount loans at the maximum rate, without regard to the actual yield, will not be affected. National banks located in states that permit state lenders to discount only to the extent that the actual yield is within the statutory maximum will need to change their practices merely by charging the statutory rate only when it becomes due, or by charging a lower rate in advance that yields an effective rate not in excess of the maximum. Furthermore, the impact of the instant decision on national banks will be practically limited to consumer loans, because of the usual exemption of corporations from usury laws[33] and of section 85's higher alternative rate for business or agricultural loans.[34] This limited restriction on the national banks will be justified by its beneficent effect on the borrower[35] and on the competing state lenders,[36] who

33. Typically, a corporation may not plead usury as a defense. Over thirty states exempt loans to corporations from the usury ceilings. Indeed, it has heen estimated that usury laws cover only 40-50% of lending. M. Benfield, Jr., *Usury Laws and Consumer Credit*, 26 BUS. LAWYER 787 (1971).

34. The amendment to section 85, enacted October 28, 1974, that permits the national bank-lender of a business or agricultural loan to choose the higher of the state rate or 5% in excess of the local Federal Reserve discount rate, provides a means to avoid completely any state rate that is below market rate. (*See* note 6 *supra* for the provisions of section 85). Pub. L. No. 93-501, § 201 (Oct. 29, 1974).

35. The public regulation of banking to preserve banking competition . . . aims primarily at protecting users of bank credit, by preventing their monopolistic exploitation by banks. . . . Its method consists of attempting to assure borrowers of a reasonable number of alternative sources of credit accommodations.

C. Kreps, *Modernizing Banking Regulation*, 31 LAW & CONTEMP. PROB. 648, 670 (1966).

The argument that the instant decision will further restrict consumers' access to loan funds because national banks will be unable to make low interest loans at a profit fails to consider that the national bank's rate ceiling is determined by the preferred lender rate, which may be as high as 25%, or higher. Thus, while the state bank's low interest rate may sometimes render consumer loans prohibitive, the national bank's preferred rate will seldom have such a result.

Granted, in the few states having a lower preferred rate, such as Arkansas, the rate ceilings may limit the availability of consumer credit and ensure the existence of gray markets and loan sharking. The solution in these states is to enable consumers to obtain loans not by applying state rates unevenly to state lenders and national banks, but by revising usury statutes in an evenhanded manner toward all lenders. For a thorough discussion of the effects of rate ceilings on consumer loans and the solutions offered by the UCCC, see Symposium, *Consumer Credit in the 70's*, 26 BUS. LAWYER 753, 753-904 (1971).

36. The cost of money to state banks, not members of the Federal Reserve, is invariably

have always been subject to the state restrictions.[37] The restriction is justified not only on the above equitable grounds, but also on logical and legal grounds. A discounted installment loan creates a greater burden on the borrower than does a discounted single payment short-term loan, and therefore deserves special treatment. Both types of loans yield a gain to the lender in excess of the stipulated rate because the interest is based on the face amount of the note rather than on the net principal actually lent. The installment loan, however, increases this excess yield because the interest is based on the full amount of the prinicpal, without allowance for its progressive reduction by the periodic payments through the course of the loan. While one might tolerate the first excess, shared by both loans, as *de minimus* and justified by banking convenience, one might not so easily tolerate the added excess, unique to the installment note, on the same grounds. Because of the distinction, the same court that decided *Evans* in favor of national banks might well decide an installment loan case in favor of the borrower. By confining *Evans* to its facts[38] the Supreme Court would be reaffirming its

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higher than the cost to national banks and member state-chartered banks, because of the Fed's lender-of-last resort policy. Although the state bank may have a more liberal reserve requirement, once it has exhausted its own liquid assets short of the reserve it faces a liquidity crisis when it cannot borrow funds at reasonable rates. In view of the advantages afforded the national banks by the Federal Reserve System, the national bank would receive a competitive windfall if given discounting privileges not allowed to state banks. *See generally, Part I: Banking Regulation*, 31 LAW & CONTEMP. PROB. 635, 635-773 (1966).

37. For a discussion of the importance of maintaining the duality of our banking system through competitive equality, see Comment, 58 IOWA L. REV. 1250, 1266-67; Davis, *Banking Regulation Today: A Banker's View*, 31 LAW & CONTEMP. PROB. 639, 643 (1966); E. Redford, *Dual Banking: A Case Study in Federalism*, 31 LAW & CONTEMP. PROB. 749, 770-71 (1966).

Foremost among the arguments favoring the dual system are the goals of innovation, initiative and independence, inherent in the nation's system of federalism. Both the state and national systems have contributed progressive innovation, but particularly noteworthy are the state's introduction of branching, loans on real estate and fiduciary operations, all of which were later incorporated into the competing federal system.

38. At least one commentator suggests that the *Evans* rule is desirable when confined to federal rejection of unusual and unreasonable state restrictions. A body of federal law would replace foolish restrictions of local usury laws, thereby forcing state legislatures to amend their laws to allow local lenders to compete successfully with national banks. H. Shanks, *Special Usury Problems Applicable to National Banks*, 87 BANK. L.J. 483, 497-500 (1970).

One response to this approval of the creation of federal common law in unusual rate cases is that the impetus to state law revision should come from somewhere other than another body issuing its own set of bank regulations. Already lending institutions are subject to the laws, regulation and supervision of agencies of fifty states and of at least five federal agencies. Further segmentation of that regulatory scheme by permitting the Supreme Court to establish a federal common law in hard cases is hardly desirable. Because of the problems inherent

own position of adherence to state interpretations, as it declared in *Union National Bank* and *Citizens National Bank*, and remaining faithful to its policy of "competitive equality" between national banks and state lenders, as it announced in two recent National Bank Act cases.[39] To permit national banks to discount loans in a manner denied state lenders would not only result in an unwarranted extension of *Evans*, but also would result in an unwise extension of *Tiffany* by placing national banks free of all limitations imposed upon the preferred state lenders, thereby protecting national banks from the legitimate and desirable competition contemplated by the nation's dual banking system.

LINDA A. BUNSEY

Constitutional Law—First Amendment—Punitive Damages in Defamation Actions Brought by Public Figures Chill First Amendment Rights and Are Unconstitutional Unless Narrowly and Necessarily Promoting Compelling State Interest

I. FACTS AND HOLDING

Defendant,[1] a public figure who had been sued by a public figure[2] for defamation,[3] moved for partial summary judgment to preclude recovery of punitive damages after he had been found lia-

in sanctioning a federal common law in this area, it is arguahle that the instant decision would he desirable even if the discount restrictions in Arkansas were unduly onerous to lenders.

39. *See* cases cited note 32 *supra*. *Accord*, Lewis v. Fidelity & Deposit Co., 292 U.S. 559, 564-65 (1934).

Interestingly, Retired Associate Justice Tom C. Clark, who wrote the *Walker* opinion, was one of the three judges participating in the instant decision. His participation may lend some weight to speculation that the Supreme Court today would reaffirm the policy of parity expressed in *Walker*. In particular, note Justice Clark's statement in *Walker* that "[i]t is a strange argument that permits one to pick and choose what portion of the law binds him." 385 U.S. at 261. Hopefully, the Supreme Court would find it a strange argument that permits a national bank to choose the state statutory rate and choose not to follow state law construing and applying that rate.

1. Defendant Hughes Tool Company (now known as Summa Corporation) assumed responsibility for its sole shareholder, Howard R. Hughes.

2. The parties had stipulated that both Hughes and his former employee, plaintiff Robert A. Maheu, were public figures and that the subject matter concerned a public event.

3. During a telephonic press conference on January 7, 1972, in reference to plaintiff, Hughes stated, "[H]e's a no-good, dishonest son-of-a-bitch, and he stole me blind. . . . [Y]ou wouldn't think it could be possible with modern methods of hookkeeping and so forth for a thing like the Maheu theft to have occurred, but believe me it did, because the money is gone and he's got it."

ble by a jury in the first phase of a bifurcated trial.[4] Contending that punitive damages chill rights granted under the first amendment,[5] defendant challenged the constitutionality of awarding punitive damages in a defamation suit brought by a public figure. Plaintiff maintained that both compensatory and punitive damages could be awarded when "actual malice"[6] accompanied defamation of a public figure, because the state's interests in protecting reputation and privacy were important and substantial. Plaintiff further asserted that punitive damages, which were specifically allowed under a California statute[7] upon a showing of "ill will,"[8] would be especially appropriate if reprehensible conduct could be proved. Rejecting plaintiff's arguments, the United States District Court for the Central District of California, *held*, defendant's motion for partial summary judgment granted. A state's attempt to protect reputation and privacy by granting punitive damages in defamation actions brought by public figures has an unconstitutional chilling effect upon the exercise of first amendment rights unless the attempt is manifested in a statute that narrowly and necessarily promotes a compelling state interest. *Maheu v. Hughes Tool Co.*, 384 F. Supp. 166 (C.D. Cal. 1974).

II. BACKGROUND

Defamation law was developed in response to the recoguition that "the truth never catches up with the lie . . . ."[9] and was designed to promote avoidance of self-help methods, such as the feud and duel, by inducing resort to courts for civilized relief. Its purposes are compensation, vindication, and deterrence, and the traditional remedy is an award of compensatory damages. Additionally, although a few states do not permit recovery of punitive damages

4. Defendant had admitted that Hughes' utterance satisfied all elements necessary to fix liability, if the jury found that the utterance was untrue. Moreover, defendant had conceded that Hughes' utterance was made with actual malice, if the jury found that the utterance was untrue.

5. "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people peaceably to assemble and to petition the Government for a redress of grievances." U.S. CONST. amend. I.

6. *See* text accompanying note 20 *infra*.

7. "Exemplary damages; when allowable: In an action for the breach of an obligation not arising from contract, where the defendant has been guilty of oppression, fraud, or malice, express or implied, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant." CAL. CIV. CODE § 3294 (West 1970). Punitive damages also are known as exemplary or vindictive damages.

8. Ill will is the common law definition of malice.

9. Kalven, *The Reasonable Man and the First Amendment: Hill, Butts, and Walker*, 1967 SUP. CT. REV. 267, 300.

because the propriety and amount of these awards usually are questions left to the unbridled discretion of the jury and the award of compensatory damages is considered adequate to serve the purposes of defamation law,[10] most states do allow recovery of punitive damages, when malice is shown, as a dissuasion from and penalty for defamation.[11] Prior to 1964, however, a majority of states recognized a qualified privilege of "fair comment,"[12] which allowed all members of society to offer any comment, criticism, or opinion concerning any public fignre or issue,[13] and a minority extended this privilege to those who in good faith offered misstatements of fact concerning these public topics.[14]

Although the guarantees of free speech and press embodied in the Bill of Rights seem an obvious restriction upon defamation law,

10. In Washington, punitive damages are not allowed in defamation cases. Farrar v. Tribune Pub. Co., 57 Wash. 2d 549, 358 P.2d 792 (1961); Ott v. Press Pub. Co., 40 Wash. 308, 82 P. 403 (1905). Indeed, they are not allowed in any tort cases. Spokane Truck & Dray Co. v. Hoefer, 2 Wash. 45, 25 P. 1072 (1891) (The court stated, "The plaintiff is made entirely whole. The bond has been paid in full. Surely the public can have no interest in exacting the pound of flesh. . . . It is to be presumed that the state has fully protected its own interests, or as fully at least as they could be protected by laws, when it provides for the punishment of crime in criminal statutes . . . ." *Id.* at 53, 25 P. at 1074.). In Indiana, punitive damages are not allowed in defamation cases when the defendant is subject to criminal prosecution. Wabash Print. & Pub. Co. v. Crumine, 123 Ind. 89, 21 N.E. 904 (1889). In Connecticut, punitive damages are limited in defamation cases to the cost to the plaintiff of litigation, less taxable costs. Proto v. Bridgeport Herald Corp., 136 Conn. 557, 72 A.2d 820 (1950); Hassett v. Carroll, 85 Conn. 23, 81 A. 1013 (1911). Indeed, they are so limited in all tort cases. Hanna v. Sweeney, 78 Conn. 492, 62 A. 785 (1906) (The court said that the doctrine of punitive damages in other states is wrong because "the amount of punitive damages that might be awarded [is] left almost entirely to the discretion of the jury . . . ." *Id.* at 493, 62 A. at 785.).

11. *See, e.g.*, Davis v. Hearst, 160 Cal. 143, 116 P. 530 (1911); Childers v. San Jose Mercury Print. & Pub. Co., 105 Cal. 284, 38 P. 903 (1894); Toomey v. Farley, 2 N.Y.2d 71, 138 N.E.2d 221, 156 N.Y.S.2d 840 (1956), in which the court stated,

> "Punitive or exemplary damages are intended to act as a deterrent upon the libelor so that he will not repeat the offense, and to serve as a warning to others. They are intended as punishment for gross misbehavior for the good of the public and have been referred to as 'a sort of hybrid between a display of ethical indignation and the imposition of a criminal fine.' Punitive damages are allowed on the ground of public policy and not because the plaintiff has suffered any monetary damages for which he is entitled to reimbursement; the award goes to him simply because it is assessed in his particular suit. The damages may be considered expressive of the community attitude towards one who willfully and wantonly causes hurt or injury to another."

Id. at 83, 138 N.E.2d at 228, 156 N.Y.S.2d at 849 (quoting from Reynolds v. Pegler, 123 F. Supp. 36, 38 (S.D.N.Y. 1954), *aff'd*, 223 F.2d 429 (2d Cir.), *cert. denied*, 350 U.S. 846 (1955)). *See generally* Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173 (1931).

12. *See generally* Note, *Recent Developments Concerning Constitutional Limitations on State Defamation Laws*, 18 VAND. L. REV. 1429 (1965). A qualified privilege provides conditional immunity; it protects a defamer from liability, unless bad faith and knowledge of falsity are shown.

13. *See, e.g.*, Post Pub. Co. v. Hallam, 59 F. 530 (6th Cir. 1893) (the leading case).

14. *See, e.g.*, Coleman v. MacLennan, 78 Kan. 711, 98 P. 281 (1908) (the leading case).

it was not until 1964 that the Supreme Court applied the first amendment to this body of law. The Court in 1925 did make these freedoms applicable to the states[15] and in 1931 did proscribe prior restraints.[16] Later, in the 1959 decision of *Barr v. Matteo*,[17] the Court granted an absolute privilege to federal officials to utter defamatory statements in the course of their duties. *Barr* also contained a portentous dissent[18] urging a balancing of interests between defamer and defamed. Finally, in 1964 the Court decided *New York Times Co. v. Sullivan*,[19] a suit by a city commissioner for defamatory publication of a paid advertisement that falsely described his treatment of protesters. In a decision by Justice Brennan, the Court held that a "public official" could recover only if he proved clearly and convincingly "that the statement was made with 'actual malice'—that is, with knowledge that it was false or with reckless disregard of whether it was false or not."[20] Thus, the Court had set a strong standard against liability for the defamer and consequently had placed in jeopardy recovery of both compensatory and punitive damages by the defamed. The rationale underlying the Court's holding was two-fold: the need to balance the privilege granted in *Barr* to public officials against the interests of others, and the need to discourage self-censorship and encourage public discussion unhampered by fear of large damage recoveries in defamation actions.[21] Three concurring justices[22] urged that these bases required an absolute privilege—a position doggedly maintained by this minority in later cases.[23]

During the next seven years, the Court attempted to build upon its *Sullivan* foundation and to clarify the first amendment's effect in this new area of federal law. The Court's decisions, broadening the class against whom the constitutional privilege could be invoked

15. Gitlow v. New York, 268 U.S. 652 (1925).

16. Near v. Minnesota, 283 U.S. 697 (1931).

17. 360 U.S. 564 (1959).

18. *Id.* at 578 (Warren, C.J., dissenting).

19. 376 U.S. 254 (1964).

20. *Id.* at 279-80.

21. The Court said, "[W]e consider this case against the background of a profound national commitment to the principle that debate on public issues should be uninbibited, robust, and wide-open . . . ." *Id.* at 270.

22. *Id.* at 293, 297 (Black & Douglas, J.J., concurring, & Goldberg & Douglas, J.J., concurring).

23. *See, e.g.*, Cantrell v. Forest City Pub. Co., 95 S. Ct. 465, 471 (1974) (Douglas, J., dissenting); Curtis Pub. Co. v. Butts, 388 U.S. 130, 170 (1967) (Black, J., dissenting); Garrison v. Louisiana, 379 U.S. 64, 80 (1964) (Douglas, J., concurring). An absolute privilege provides complete immunity; it protects a defamer from liability, even if bad faith and knowledge of falsity could be shown.

from public officials to "public figures"[24] and applying the first amendment to the area of privacy,[25] seemed to support predictions that the nature of events would replace the status of persons as the controlling determinant for invocation of the privilege[26] and appeared to indicate a move toward the absolute privilege position espoused by the minority in *Sullivan*. Further, the Court necessarily abandoned privilege balancing[27] in favor of an approach that balanced the interests of defamer and defamed,[28] and after vacillating between strict and mild interpretations of "reckless disregard," the Court eventually seemed to adopt the latter as part of its actual malice standard.[29] Nevertheless, viewed now in retrospect, seven years after *Sullivan*, three key problems still remained: 1) the standard of liability for the defamer, 2) the standard for recovery against the defamer, and 3) the remedies in addition to or in lieu of damages for the defamed.

The Court's 1971 and 1974 decisions in *Rosenbloom v. Metro-*

24. *See, e.g.*, Curtis Pub. Co. v. Butts, 388 U.S. 130 (1967); Rosenblatt v. Baer, 383 U.S. 75 (1966).

25. *See, e.g.*, Time, Inc. v. Hill, 385 U.S. 374 (1967). Although it has relied upon first amendment analysis, the Court continually has attempted to distinguish cases concerning defamation and invasion of privacy through false light in the public eye. *See, e.g.*, Cantrell v. Forest City Pub. Co., 95 S. Ct. 465 (1974). At least one eminent commentator, however, finds an historical link between the privileges of puhlicizing the activities of those already in the public eye and of giving publicity to news, the two being "only different phases of the same thing." PROSSER, THE LAW OF TORTS 823 (4th ed. 1971).

26. *See, e.g.*, Kalven, *The New York Times Case: A Note on "The Central Meaning of the First Amendment,"* 1964 SUP. CT. REV. 191.

27. *See, e.g.*, Rosenblatt v. Baer, 383 U.S. 75 (1966) (The Court stated, "[W]e reject any suggestion that our references in *New York Times* . . . to *Barr v. Mateo* mean that we have tied the *New York Times* rule to the rule of official privilege. The public interests protected by the *New York Times* rule are interests in discussion, not retaliation . . . ." *Id.* at 84-85 n.10.). The Court's abandonment of privilege balancing was necessitated by its broadening of the class against whom the constitutional privilege could be invoked from public officials to public figures.

28. Balancing tests are customary in other first amendment areas. In prior restraint analysis, a presumption of invalidity also appears. *See, e.g.*, New York Times Co. v. United States, 403 U.S. 713 (1971). One commentator has stated,

> Prior restraints are traditionally subject to a presumption of invalidity which only the most compelling government interest can rebut. Although a balancing of interests is thus implicit in prior restraint analysis, it takes place only after a general determination that prior restraints are a peculiarly invidious infringement. The scales in the subsequent balance are thus set in advance against the government interests served by such restraints.

The Supreme Court, 1973 Term, 88 HARV. L. REV. 41, 178 (1974). *See generally* Emerson, *The Doctrine of Prior Restraint*, 20 LAW & CONTEMP. PROB. 648 (1955).

29. *See, e.g.*, St. Amant v. Thompson, 390 U.S. 727 (1968) (The Court said that reckless disregard comprised situations in which "the publisher was aware of the likelihood that he was circulating false information" or in which he "in fact entertained serious doubts as to the truth of his publication." *Id.* at 731.); Curtis Pub. Co. v. Butts, 388 U.S. 130 (1967); Henry v. Collins, 380 U.S. 356 (1965); Garrison v. Louisiana, 379 U.S. 64 (1964).

media, Inc.[30] and *Gertz v. Robert Welch, Inc.*[31] attempted to resolve these problems. In *Rosenbloom*, a suit by a magazine distributor for defamatory publication of radio newscasts that falsely described him and his magazines as lewd, the Court held the *Sullivan* actual malice standard applicable, even though Rosenbloom was a private figure, and consequently he received neither compensatory nor punitive damages. The plurality opinion by Justice Brennan for three members of the Court emphasized again the need for debate on public issues and the need to dissuade self-censorship, and the opinion attempted to discard the public figure test in favor of a "public event" test, which the plurality thought balanced more meaningfully the public's right to know against the individual's right to privacy. Justice Brennan also mentioned retraction and right-to-reply statutes as alternative remedies for the defamed.[32] Justices Marshall and Stewart in a joint dissent[33] and Justice Harlan in a separate dissent[34] favored retention of the public figure test and proposed a milder negligence standard, as opposed to the actual malice standard, for recovery of compensatory damages by private persons. Regarding recovery of punitive damages by private persons, Justices Marshall and Stewart advocated abolition, and Justice Harlan suggested a modified actual malice standard with unspecified control upon jury discretion.[35] Justice Harlan also suggested that the bases for a distinction between public and private figures were that public figures voluntarily have thrust themselves into the vortex of public activity and have effective opportunity to communicate rebuttal, but Justice Brennan rejected this two-pronged rationale as "at best, a legal fiction."[36]

Justice Harlan's *Rosenbloom* view, however, was adopted in *Gertz* by five justices.[37] In *Gertz*, a suit by an attorney for defamatory publication of an article that falsely described him as communist, the Court, in a majority opinion by Justice Powell, immediately returned the focus in defamation cases to the public-private figure dichotomy, stated that it had "no difficulty in distinguishing among

30. 403 U.S. 29 (1971).

31. 418 U.S. 323 (1974).

32. Justice Black in a concurring opinion again advocated an absolute privilege. 403 U.S. at 57 (1971) (Black, J., concurring).

33. *Id.* at 78 (Marshall & Stewart, J.J., dissenting).

34. *Id.* at 62 (Harlan, J., dissenting).

35. In a concurring opinion Justice White concluded that five justices favored a limitation upon punitive damages—the three dissenters, Justice Black and the absent Justice Douglas. *Id.* at 57 (White, J., concurring).

36. *Id.* at 48.

37. Justices Powell, Rehnquist, Marshall, Stewart, and Blackmun constituted the emerging majority.

defamation plaintiffs,"[38] and determined that Gertz was a private figure. Then, relying upon Justice Harlan's two-pronged rationale,[39] the Court held that awards of compensatory damages should be determined according to a negligence standard for private persons and the actual malice standard for public persons. Additionally, the Court stated that compensatory damages could be awarded for "out-of-pocket loss, . . . impairment of reputation and standing in the community, personal humiliation, and mental anguish and suffering."[40] The Court also held that neither private nor public persons should recover punitive damages, "at least when liability is not based on a showing of knowledge of falsity or reckless disregard for the truth."[41] The Court stated that although punitive damages are "levied by civil juries to punish reprehensible conduct and to deter its future occurrence," states have no substantial interest in granting these "gratuitous awards of money damages far in excess of any actual injury," when juries "remain free to use their discretion selectively to punish expressions of unpopular views."[42] Accordingly, the Court felt that Gertz should not recover punitive damages.[43] Justice Brennan in dissent[44] again mentioned retraction statutes as an alternative remedy for the defamed. Justice Blackmun in a separate opinion[45] felt that with *Gertz* the law finally had "come to rest in the defamation area . . . ."[46]

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38. 418 U.S. 323, 344 (1974).

39. The Court stated,

> Public officials and public figures usually enjoy significantly greater access to the channels of effective communication and hence have a more realistic opportunity to counteract false statements than private individuals normally enjoy. . . .
>
> . . . An individual who decides to seek governmental office must accept certain necessary consequences of that involvement in public affairs. He runs the risk of closer public scrutiny than might otherwise he the case. . . .
>
> Those classed as public figures stand in a similar position. . . . For the most part those who attain this status have assumed roles of especial prominence in the affairs of society . . . [and] have thrust themselves to the forefront of particular public controversies . . . . [T]hey invite attention and comment.
>
> . . . [T]he communications media are entitled to act on the assumption that public officials and public figures have voluntarily exposed themselves to increased risk of injury from defamatory falsehoods concerning them. No such assumption is justified with respect to a private individual.

Id. at 344-45.

40. *Id.* at 350.

41. *Id.* at 349.

42. *Id.* at 350.

43. Justice Douglas in a dissenting opinion again advocated an absolute privilege. *Id.* at 355 (Douglas, J., dissenting).

44. *Id.* at 361 (Brennan, J., dissenting).

45. *Id.* at 353 (Blackmun, J., concurring).

46. *Id.* at 354 (Blackmun, J., concurring).

III. The Instant Opinion

The instant court initially noted that the issue of first amendment preclusion of punitive damages in a defamation action brought by a public figure was of first impression and then cited the Supreme Court's recent aversion to punitive damages in defamation suits by quoting from the majority opinion in *Gertz* and Justices Marshall and Stewart in *Rosenbloom*. Next the court determined that punitive damages have a chilling effect upon first amendment rights because of the threats of costly litigation and great compensatory recoveries and said that the *Sullivan* actual malice standard provides protection only at the threshold of liability. Reasoning that self-censorship, especially of unpopular views, still would be invited by fear of punitive damages, the court held that punitive damages could not be awarded to public figures in defamation actions "unless they narrowly and necessarily further important and substantial state interests."[47] Applying this analysis, the court then identified two state interests—the protections of reputation and privacy—but rejected them as not compelling. The first interest was minimized by the specter of costly litigation, the broad definition of compensatory damages in *Gertz*, and the two-pronged rationale employed in *Gertz* to distinguish public figures; the second interest was minimized by the public figure's presumed consent to invasion of privacy. Thus, the court concluded that both interests were outweighed by considerations of the public's right to know and the first amendment. Additionally, the court found in the California statute[48] a third, more important and more substantial state interest—protection "when reputation and privacy are threatened by the special dangers flowing from highly motivated, tortious conduct, *i.e.*, reprehensible conduct that is motivated by ill will,"[49] a situation in which more than just actual malice is present. Although the court accepted the state's conclusion that greater probability and larger maguitude of harm would result when a tort is committed under aggravated circumstances, it nevertheless rejected this third interest as not compelling in defamation actions brought by public figures. While recoguizing the two-pronged rationale employed in *Gertz*, the court preferred to rest its rejection upon another ground: the California statute's use of punitive damages as the means to protect against the special dangers was too drastic. Because the jury had unbridled discretion to determine the propriety and amount of

47. 384 F. Supp. at 170.
48. *See* note 7 *supra*.
49. 384 F. Supp. at 172.

punitive damages and hence to punish unpopular views, the court found that the approach chosen was not narrowly restricted to deterrence of reprehensible conduct. The court further found that this overbroad approach was not necessarily required for deterrence of the proscribed conduct because feasible alternative remedies were available.[50] Thus, as to this third interest, the court invalidated that part of the statute allowing recovery of punitive damages by public figures in defamation suits as an unconstitutional violation of the first amendment. Therefore, the court concluded that because the grant of punitive damages in a defamation action brought by a public figure has a chilling effect upon the exercise of first amendment rights, the recovery of these awards is unconstitutional unless they narrowly and necessarily promote a compelling state interest.

IV. COMMENT

With the instant decision, federal defamation law has advanced within the space of ten years from no constitutional privilege, even for the press in defending against a public person, to the realized prospect of a constitutional privilege so sweeping that it prevents recovery of an element of damages by a public person who has been defamed by an individual. Specifically, the instant court's holding completes a four-part scheme for liability and damages in defamation actions: under Supreme Court decisions, a private figure must prove negligence to receive compensatory damages and actual malice to receive punitive damages, and a public figure must prove actual malice to recover compensatory damages; under the instant decision, a public figure is almost totally precluded from recovering punitive damages. As the *Sullivan* Court in large measure adopted the minority position concerning fair comment and liability, so too the *Maheu* court in large measure adopted the minority position concerning punitive damages.[51] Nevertheless, the instant decision was solidly based: the court fully considered the Supreme Court's prior concerns with encouraging debate and discouraging self-censorship, shielding reputation and privacy, and, most importantly, scrutinizing the need for punitive damages.[52]

50. The court listed 4 potential alternatives: 1) a ceiling upon punitive damages, 2) a ratio between compensatory and punitive damages, 3) criminal sanctions against defamation, and 4) recovery of court costs and attorney's fees.

51. *See* note 10 *supra*.

52. The court did not mention possible constitutional differences between libel and slander, falsehoods and insults, defamation by a public figure and by the press, and freedom of speech and freedom of the press. The first phase of the bifurcated trial in the instant case settled the first two issues; the broad holdings of the Supreme Court seem to settle the last two.

In one area, however, the instant court did break new ground. By presuming the invalidity of punitive damages and hence requiring the showing of a compelling state interest, the court added a new dimension to the balancing process in defamation actions brought by public figures. This setting of the scales in advance provides greater protection for speech and the press than does the Supreme Court's ad hoc balancing approach. Thus, the instant court's analysis would leave the door to punitive damages only slightly ajar for public figures and implicitly almost totally open for private figures. In distinguishing between public and private figures, however, the court relied heavily upon the *Gertz* two-pronged rationale—a formulation that has been intensely criticized.[53] As to the public figure's voluntary exposure to publicity, Justice Brennan has stated, "[T]he idea that certain 'public' figures have voluntarily exposed their entire lives to public inspection, while private individuals have kept theirs carefully shrouded from public view is, at best, a legal fiction."[54] As to the public figure's capacity for rebuttal, Justice Powell himself has stated, "[A]n opportunity for rebuttal seldom suffices to undo harm of defamatory falsehood."[55] Moreover, in distinguishing between public and private figures, the instant court did not mention and the majority in *Gertz* apparently minimized two important state interests that seem applicable to all persons: the state interests in preserving defamation law firstly because it reflects the "basic concept of the essential diguity and worth of every human being"[56] and secondly because it "aids democracy when it deters wholly unfounded smear campaigus."[57] Nevertheless, the instant court's completion of the four-part scheme for liability and damages is consistent with the implications of *Gertz*.

Whether the Supreme Court ultimately will follow its own suggestions in *Gertz* and the lead of the instant case or will adopt completely the suggestions and lead of Justice Harlan in *Rosenbloom* is an open question. If the Court follows the latter

53. *See, e.g., The Supreme Court, 1973 Term*, 88 HARV. L. REV. 41 (1974), in which it is stated, "Properly to determine which social roles suhject their occupants to heing classified as public figures is, however, a difficult task." *Id.* at 145. "The *Gertz* Court's 'social role' test is problematic because it is vague and perhaps capricious in application . . . ." *Id.* at 145 n.37. "Thus, there appears to be no bright-line test for determining when increased publicity is an actual social expectation; rather, the test appears to be based on an ad hoc sociological perception." *Id.* at 145-46.

54. Rosenbloom v. Metromedia, Inc., 403 U.S. 29, 48 (1971).

55. Gertz v. Robert Welch, Inc., 418 U.S. 323, 344 n.9 (1974).

56. Rosenblatt v. Baer, 383 U.S. 75, 92 (1966).

57. *The Supreme Court, 1973 Term*, 88 HARV. L. REV. 41, 147 n.50 (1974). *See generally* Reisman, *Democracy and Defamation: Fair Game and Fair Comment I*, 42 COLUM. L. REV. 1085 (1942).

course and expressly adopts the *Sullivan* actual malice standard for recovery of punitive damages by both private and public figures, then the law truly may come to rest in the defamation area or, at most, future disputes will be limited only to clarifying the definition of reckless disregard. If the Court follows the former course and adopts a presumption of invalidity, then recovery of punitive damages eventually might be endangered for both public and private figures. This was the result advocated by Justices Marshall and Stewart in *Rosenbloom* as the necessary method to dissuade self-censorship. Thus, although the instant court ostensibly followed the dictates of *Gertz*, which seemed to slow or even reverse the momentum toward an absolute constitutional privilege, the instant decision ironically may have speeded this momentum. Additionally, further impetus toward adoption of the absolute privilege position are the fears expressed by the court in *Maheu* that the broad definition of compensatory damages in *Gertz* still allows great jury discretion and engenders self-censorship and that the high costs of litigating a defamation suit deter fearless publication.

In any event, because recovery of punitive damages, at least for public figures, now may be more difficult, less drastic alternatives are needed to deter defamation. The instant court's first two suggested alternatives, a ceiling upon punitive damages and a ratio between compensatory and punitive damges, are subject to the same infirmities as are punitive damages in general. The third and fourth alternatives, criminal sanctions against defamation and recovery of court costs and attorney's fees, each of which already is employed in at least one state,[58] are feasible surrogates. Nevertheless, the possibility exists that a defamation may go without redress and that the defamed may have no opportunity to vindicate reputation, either because he cannot satisfy the requisite liability standard or because an absolute constitutional privilege eventually may be adopted. The potential remedies for these situations are numerous. Although the Supreme Court in *Miami Herald Publishing Co. v. Tornillo*[59] recently dealt an apparent deathblow to right-to-reply statutes, the possibility of paid rebuttal advertisements remains.[60] A more efficient and economical alternative, however, is the retraction statute.[61] In both his dissenting opinion in *Gertz* and his concur-

58. *See* note 10 *supra.*

59. 418 U.S. 241 (1974).

60. *See The Supreme Court, 1973 Term*, 88 HARV. L. REV. 41, 180 (1974).

61. *See generally* Reisman, *Democracy and Defamation: Fair Game and Fair Comment II*, 42 COLUM. L. REV. 1282 (1942); Comment, *Reply and Retraction in Actions Against the Press for Defamation: The Effect of Tornillo and Gertz*, 43 FORDHAM L. REV. 223 (1974).

ring opinion in *Tornillo*,[62] Justice Brennan noted that a retraction statute affording relief on a strict liability basis to plaintiffs able to prove defamatory falsehood by requiring public retraction without an assessment of damages probably would be constitutional. Another possible solution is a declaratory judgment without retraction, which also would provide for truth, vindication, and no compensation. Finally, a combination of these alternatives may serve best the interests of the defamed and the defamer, of society and the Constitution. For example, a declaratory judgment, and if necessary a public retraction, could be joined with an award of court costs and attorney's fees. This solution in effect would combine absolute freedom with absolute liability but would not have the chilling impact occasioned by punitive or even compensatory damages.

Thus, as is evidenced by the availability of these alternatives, current limitations upon defamation law affect only recovery of damages and not the existence of a cause of action. Nevertheless, freedom of speech and freedom of the press remain specific commands of the first amendment, and as the Supreme Court has intimated recently, although responsible speech and a responsible press are undoubtedly desirable goals, they are not mandated by the Constitution.[63]

DAVID M. THOMPSON

Constitutional Law—Guilty Plea—Federal Habeas Corpus Relief Available When State Statute Permits Post-Guilty Plea Appellate Review of Constitutional Challenges

I. FACTS AND HOLDING

Respondent, arrested for violating a New York loitering statute,[1] was charged with loitering and two narcotics offenses[2] on the basis of evidence obtained in a search incident to his arrest. Alleging the unconstitutionality of the loitering statute and, therefore, the

62. 418 U.S. 241, 258 (Brennan, J., concurring).
63. *Id.* at 256.

1. N.Y. PEN. LAW § 240.35(6) (McKinney 1967).
2. Respondent was charged with possession of a dangerous drug, fourth degree, N.Y. PEN. LAW § 220.05 (now codified as modified as N.Y. PEN. LAW. § 220.03 (McKinney 1973)), and criminally possessing a hypodermic instrument. N.Y. PEN. LAW § 220.45 (McKinney 1967).

illegality of the resulting search, respondent moved to suppress the narcotics evidence,[3] but the New York City Criminal Court found him guilty of the loitering charge and denied his motion to suppress. On the date scheduled for trial on the drug charges, respondent withdrew his prior pleas of not guilty and entered a plea of guilty to a lesser drug offense.[4] Simultaneously, respondent, relying on a New York statute[5] that permits an appeal challenging certain constitutional defects[6] after a guilty plea has been accepted, announced his intention to appeal the denial of his motion to suppress and his loitering conviction. After unsuccessfully exhausting his direct appeals,[7] respondent filed a petition for a writ of habeas corpus[8] in federal district court. Prior to the district court's decision on the merits of respondent's petition, the New York Court of Appeals declared the loitering statute unconstitutional,[9] and in response to this decision the district court granted respondent's petition for a writ of habeas corpus. The Second Circuit Court of Appeals affirmed[10] both the grant of habeas corpus[11] and the invalidation of the loitering statute.[12] To resolve a conflict between circuits,[13] the Su-

3. Respondent advanced three arguments to support his motion: (1) the arresting officer did not have probable cause to arrest him; (2) the evidence introduced was insufficient to support the loitering conviction; and (3) the loitering statute was unconstitutionally vague and, therefore, could not support the loitering conviction or a search incident to arrest.

4. Respondent pleaded guilty to the interesting charge of attempted possession of dangerous drugs. N.Y. PEN. LAW § 110 (McKinney 1967). He was sentenced to ninety days imprisonment for the attempted possession conviction and was given an unconditional release on the loitering conviction.

5. N.Y. CODE CRIM. PROC. § 813-c, now recodified as N.Y. CRIM. PROC. LAW §§ 710.20(1), 710.70(2) (McKinney 1971).

6. N.Y. CRIM. PROC. LAW §§ 710.20(1), 710.70(2) (McKinney 1971) authorize appeal of an adverse ruling on a claim of unlawful search and seizure; N.Y. CRIM PROC. LAW §§ 710.20(3), 710.70(2) (McKinney 1971) permit a similar appeal from a denial of a motion to suppress an allegedly coerced confession; N.Y. CRIM. PROC. LAW §§ 710.20(5), 710.70(2) (McKinney 1971) permit an appeal from a denial of a motion to suppress an identification allegedly influenced by improper pretrial identifications. California has a similar statute permitting appeal from certain adverse pretrial rulings despite subsequent entry of a guilty plea. CAL. PENAL CODE § 1538.5(m) (West 1967).

7. The Appellate Term of the New York Supreme Court reversed the loitering conviction on the basis of insufficient evidence and a defective information, but found that probable cause to arrest the respondent was present and, therefore, upheld the challenged search. The New York Court of Appeals denied leave to appeal and the United States Supreme Court denied a petition for a writ of certiorari. Newsome v. New York, 405 U.S. 908 (1972).

8. 28 U.S.C. §§ 2241 et seq. (1970).

9. People v. Berck, 32 N.Y.2d 567, 300 N.E.2d 411, 347 N.Y.S.2d 33, *cert. denied*, 414 U.S. 1093 (1973).

10. United States *ex rel.* Newsome v. Malcolm, 492 F.2d 1166 (2d Cir. 1974).

11. *Id.* at 1169-71, 1174-75.

12. The court held that the statute was unconstitutionally vague and failed to provide adequate standards of conduct for prosecutors, police or the judiciary. *Id.* at 1171-74.

13. In Mann v. Smith, 488 F.2d 245 (9th Cir. 1973), *cert. denied*, 415 U.S. 932 (1974), the Court of Appeals held that a guilty plea barred federal habeas corpus relief under a

preme Court granted certiorari[14] and *held*, affirmed. When a state statutory scheme permits a defendant to plead guilty without forfeiting his right to appellate review of specified constitutional issues, the defendant is not barred from pursuing those issues in a federal habeas corpus proceeding. *Lefkowitz v. Newsome*, 43 U.S.L.W. 4284 (U.S. Feb. 19, 1975).

II. BACKGROUND

A criminal defendant's decision to plead guilty has far-reaching and pervasive effects, because he waives not only all nonjurisdictional defects in any prior stage of the proceedings,[15] but also his fundamental constitutional rights of trial by jury,[16] protection against compulsory self-incrimination,[17] and confrontation of his accusers.[18] Recognizing the seriousness of these consequences, the courts have insisted that defendant's plea be made voluntarily and knowingly if it is to operate as a waiver of these constitutional rights.[19] In *Johnston v. Zerbst*,[20] the Supreme Court enunciated the classic definition of this waiver standard as an "intentional relinquishment or abandonment of a known right or privilege."[21] Several subsequent cases[22] held that a defendant's guilty plea, obtained by pressure or coercion, would not operate as a waiver of his right collaterally to attack his conviction in a federal habeas corpus proceeding.[23] Another case that exemplified the Court's willinguess to invalidate guilty pleas because of pretrial irregularities was *Machibroda v. United States*,[24] in which the Supreme Court re-

California statute, CAL. PENAL CODE § 1538.5(m) (West 1967), quite similar to the New York provision.

14. 417 U.S. 967 (1974). Certiorari was limitied to the question whether a state defendant's guilty plea waives federal habeas corpus review of his conviction if, under that state's procedure, such post-conviction review is authorized.

15. United States *ex rel.* Glenn v. McMann, 349 F.2d 1018, 1019 (2d Cir. 1965).

16. Duncan v. Louisiana, 391 U.S. 145 (1968).

17. Malloy v. Hogan, 378 U.S. 1 (1964).

18. Pointer v. Texas, 380 U.S. 400 (1965).

19. Boykin v. Alahama, 395 U.S. 238 (1969); Waley v. Johnston, 316 U.S. 101 (1942); Walker v. Johnston, 312 U.S. 275 (1941).

20. 304 U.S. 458 (1937).

21. *Id.* at 464.

22. Pennsylvania *ex rel.* Herman v. Claudy, 350 U.S. 116 (1956); Walker v. Johnston, 312 U.S. 275 (1941).

23. In Waley v. Johnston, 316 U.S. 101 (1942), the defendant petitioned for a writ of habeas corpus, alleging that his guilty plea was the result of the threats and coercion of a police official. The Supreme Court, reversing the lower court, granted the writ on the grounds that "if his plea was so coerced as to deprive it of validity to support the conviction, the coercion likewise deprived it of validity as a waiver of his right to assail the conviction." *Id.* at 104.

24. 368 U.S. 487 (1962).

versed the dismissal of a petition for habeas corpus sought by a defendant who alleged that his guilty plea had been obtained by coercive tactics. The Court ruled that when a defendant in a federal court is not personnally questioned by the trial judge concerning the voluntary nature of his plea, as required by Rule 11, Federal Rules of Criminal Procedure,[25] his conviction is open to subsequent collateral attack.[26] In *Fay v. Noia*,[27] the Supreme Court continued to explore the concept of waiver and its effect upon the availability of federal habeas corpus relief. Defendant, who had been convicted solely upon the admission of a concededly coerced confession, chose not to pursue an appeal because he feared a new trial might result in the imposition of the death penalty.[28] Rejecting the argument that habeas corpus review was barred by the defendant's failure to exhaust state appellate procedures,[29] the Supreme Court stated that to operate as a waiver of all federal relief, the decision by a habeas applicant to by-pass state remedies, made after consultation with competent counsel, must be found to have been made knowingly and understandingly,[30] whether for strategic, tactical or other deliberate reasons.[31]

Departing from these earlier decisions in which the Court had considered pretrial events in determining the voluntariness issue, the Court, in three 1970 decisions known as the *Brady* trilogy,[32]

25. "The court may refuse to accept a plea of guilty, and shall not accept such a plea . . . without first addressing the defendant personally and determining that the plea is made voluntarily with understanding of the nature of the charge and the consequences of the plea . . . . The court shall not enter a judgment upon a plea of guilty unless it is satisfied that there is a factual basis for the plea." FED. R. CRIM. P. 11.

26. 368 U.S. at 493. The requirement of strict adherence to Rule 11 was reaffirmed in McCarthy v. United States, 394 U.S. 459 (1969), when the Supreme Court held that even though the defendant had stated a desire to plead guilty and was informed of the consequences of the plea, a court, without directly questioning the defendant, could not *assume* he had a complete understanding of the charge against him. 394 U.S. at 464. Although *McCarthy* was directly applicable only to the federal courts, 394 U.S. 459, 463-64, its requirement of an affirmative showing of voluntariness on the record was impliedly extended to the states in Boykin v. Alabama, 395 U.S. 238 (1969).

27. 372 U.S. 391 (1963).

28. *Id.* at 439-40.

29. *See* 28 U.S.C. § 2254(b) (1970), which provides in part: "An application for a writ of habeas corpus . . . shall not he granted unless it appears that the applicant has exhausted the remedies available in the courts of the State. . . ."

30. "Under no reasonable view can the State's version of Noia's reason for not appealing support an inference of deliberate by-passing of the state court system. For Noia to have appealed in 1942 would have run a substantial risk of electrocution . . . . This was a choice by Noia not to appeal, but . . . it cannot realistically he deemed . . . a deliberate circumvention of state procedures." Fay v. Noia, 372 U.S. 391, 439-40 (1963).

31. *Id.* at 439.

32. Brady v. United States, 397 U.S. 742 (1970); McMann v. Richardson, 397 U.S. 759 (1970); Parker v. North Carolina, 397 U.S. 790 (1970).

adopted a new approach that focused almost exclusively upon whether, *at the time of the plea*, the defendant's decision to plead guilty, based upon the advice of competent counsel, was voluntarily and intelligently made. In the first of these cases, *Brady v. United States*,[33] defendant, represented by counsel, changed his plea from not guilty to guilty on a kidnapping charge after a codefendant agreed to testify on behalf of the prosecution. Eight years later he sought a writ of habeas corpus, alleging that his plea had been obtained by the coercive effect of the penalty provision of the Federal Kidnapping Act[34] providing for the death penalty only upon the recommendation of a jury. The defendant's plea had been entered before this provision had been held unconstitutional[35] as placing an "impermissible burden"[36] upon the exercise of the right to a jury trial. Finding that the plea had been motivated by fear of the codefendant's testimony, and had not been coerced by the death penalty provision, the Court affirmed the district court's action dismissing the writ and held that the guilty plea had been voluntarily entered.[37] The majority further stated that even if the defendant would not have pleaded guilty except for this provision, this "does not necessarily prove that the plea was coerced and invalid as an involuntary act."[38] The second case of the trilogy, *McMann v. Richardson*,[39] consolidated three New York cases in which the defendants, alleging that their guilty pleas had been prompted by illegally obtained confessions, sought collateral relief.[40] In reversing the grant of a habeas hearing, the Court ruled that a defendant who alleges that a prior coerced confession was the reason for his guilty plea is not, without more, entitled to a hearing.[41] Each defendant had been convicted not because of his prior confession, but by his "own admission in open court that he committed the acts with which he was charged,"[42] and as long as the advice he was given by counsel was

33. 397 U.S. 742 (1970).
34. 18 U.S.C. § 1201(a) (1970).
35. United States v. Jackson, 390 U.S. 570 (1968).
36. *Id.* at 572.
37. 397 U.S. at 748.
38. *Id.* at 750.
39. 397 U.S. 759 (1970).
40. The three petitioners alleged varying degrees of physical and mental abuse, improper police and judicial pressure, and ineffective representation of counsel. *Id.* at 761-64. Until it was declared unconstitutional in Jackson v. Denno, 378 U.S. 368 (1964), New York procedure provided that if a defendant challenged the voluntariness of his confession, the trial judge admitted the confession into evidence and submitted the voluntariness issue to the jury. The *McMann* defendants claimed that because they had no constitutionally valid procedure to challenge the voluntariness of their confessions, they were forced to plead guilty.
41. 397 U.S. at 768.
42. *Id.* at 766.

"within the range of competence demanded of attorneys in criminal cases,"[43] the conviction was not open to collateral attack.[44] Another 1970 case, *North Carolina v. Alford*,[45] presented the additional problem of whether collateral relief was available when the entry of defendant's guilty plea was accompanied by protestations of innocence. The defendant was charged with first degree murder and, after examining the prosecution's case, defendant's counsel recommended pleading guilty to a lesser charge to avoid the risk that the death penalty could be imposed by a jury if the case went to trial.[46] Although still claiming innocence, the defendant accepted his attorney's advice and pleaded guilty to second degree murder. In reversing the grant of a habeas corpus hearing,[47] the Supreme Court held that "while most pleas of guilty consist of both a waiver of trial and an express admission of guilt, the latter element is not a constitutional requisite to the impostion of criminal penalty."[48] Although recognizing that a substantial split of authority exists concerning the permissibility of accepting a guilty plea accompanied by protestations of innocence,[49] the Court held that a criminal defendant may voluntarily, knowingly, and understandingly submit to a prison sentence even if he cannot or will not admit that he committed the crime with which he is charged.[50]

A 1973 decision, *Tollett v. Henderson*,[51] construed this line of cases and provided the forum for the Court's most explicit statement of the narrowed scope of the voluntariness test. The defendant, a Negro, had been indicted by a Tennessee grand jury for

43. *Id.* at 771. The Court held that counsel's failure to anticipate the ruling in Jackson v. Denno, 378 U.S. 368 (1964), was not the type of "gross error" that would vitiate the knowing and intelligent nature of the defendants' pleas. *See* note 40 *supra*.

44. The third case in the *Brady* trilogy, Parker v. North Carolina, 397 U.S. 790 (1970), addressed essentially the same issues considered in *McMann* and *Brady* and held that an intelligent and counseled guilty plea is not open to collateral attack because of alleged prior constitutional defects.

45. 400 U.S. 25 (1970).

46. North Carolina law provided life imprisonment as the maximum penalty for first degree murder if a guilty plea was entered and accepted. If the defendant chose to go to trial, the jury could recommend the death penalty. Before accepting the plea, the trial court heard a summary presentation of the State's case, and received the defendant's testimony that he was innocent but was pleading guilty to avoid the possible impostion of the death penalty. *Id.* at 28-30.

47. The Court of Appeals for the Fourth Circuit, relying heavily on United States v. Jackson, 390 U.S. 570 (1968) (*see* note 35 *supra* and accompanying text), held that the North Carolina penalty scheme was so coercive as to render Alford's plea involuntary. Alford v. North Carolina, 405 F.2d 340 (4th Cir. 1968).

48. 400 U.S. at 37.

49. *Id.* at 33-34.

50. *Id.* at 37.

51. 411 U.S. 258 (1973).

murder and, on advice of counsel, had pleaded guilty. Twenty-five years later he sought habeas corpus relief, claiming that Negroes had been excluded systematically from the grand jury that indicted him. In granting the petition for habeas corpus, the Sixth Circuit reasoned that since the facts relating to the unconstitutional grand jury selection procedures were unknown to either the defendant or his attorney, no voluntary and intelligent waiver of the constitutional claims could have occurred. The Supreme Court, however, reversed. Abandoning the content, if not the language, of the waiver concept, the Court explicitly enunciated a new standard by stating that a guilty plea represents a "break in the chain" of the events preceding it in the criminal process. While noting that if the issue was solely one of waiver, the court of appeals had been correct in concluding that no waiver had occurred,[52] the Court held that a defendant may not raise claims relating to prior constitutional deprivations once he has "solemnly admitted" his guilt in open court. After the entry of a guilty plea, the events preceding the plea are no longer subject to review, and only the voluntary and intelligent nature *of the plea itself* is open to attack on the ground that counsel's advice was not within the standards set forth in *McMann*.[53] Under the *Tollett* standard, a federal court when considering an application for federal habeas corpus is free to ignore claims of constitutional errors arising prior to the entry of a guilty plea, and should confine its inquiry to the competency of the legal advice received by the defendant and to the voluntary and intelligent nature of the defendent's decision to plead guilty instead of proceeding to trial.

III. The Instant Opinion

In rejecting the State's reliance upon the stated rule of the *Brady* trilogy and *Tollett*,[54] the instant Court noted the suggestion originally made in a *McMann* footnote[55] that an exception might exist if the applicable state law permitted appeal from adverse pretrial rulings despite a subsequent guilty plea. Under New York procedure, a defendant who chooses to plead guilty does not deliberately by-pass state appellate review of certain constitutional

52. *Id.* at 266.

53. *Id.* at 267.

54. At oral argument the New York Assistant Attorney General argued that *McMann* and *Tollett* "stood for the proposition that a state conviction based on a guilty plea is immune from all federal collateral attack except a challenge based on the validity of the plea itself." 16 BNA Crim. L. Rep. 4118 (Dec. 18, 1974).

55. 397 U.S. at 770 n.13.

claims,[56] and the State acquires no legitimate expectation of finality in the ensuing conviction. As to these constitutional claims, the plea does not constitute a "break in the chain," but operates merely as a procedural device to secure review of the adverse pretrial ruling without the necessity of a time-consuming and expensive trial.[57] The Court held that because the respondent's guilty plea was entered in reliance upon a guarantee of the availability of further appellate review of his constitutional claims,[58] it was essentially different from guilty pleas entered in other states that result in an absolute conviction and a waiver of all further state review. This difference led the Court to conclude that respondent's conviction upon a guilty plea was not meaningfully different from a conviction obtained as the result of a trial. Since entirely different expectations surrounded the plea, and entirely different legal consequences flowed therefrom, the Court's holdings in the earlier guilty plea cases were simply inapposite. The majority emphasized that the denial of a federal forum for the respondent's claims not only would deprive him of federal habeas corpus after he had satisfied all the prerequisites for that relief,[59] but also would frustrate New York's policy of encouraging the entry of guilty pleas without diminishing a defendant's opportunity to assert his constitutional rights. The Court indicated its approval of the State's attempts to reduce the burden of unnecessary litigation by providing a statutory scheme to deter a defendant, convinced that the State's case stands or falls according to the resolution of his constitutional claims, from forcing the State to conduct a lengthy and expensive trial in order to preserve his right to challenge constitutional issues, on either appeal or application for federal habeas corpus relief.[60] Recognizing that a contrary ruling would substantially impair New York's efforts to relieve docket congestion without sacrificing criminal defendants' fundamental rights, the majority affirmed the grant of a habeas corpus hearing.

Writing in dissent, Justice White[61] argued that under the prin-

56. *See* note 6 *supra*.

57. By hypothesis, the challenged evidence will be determinative of the outcome of the case. Thus the constitutional challenges to the admissibility of the evidence would be the only real issues on appeal whether the defendant pleaded guilty or was found guilty after a trial.

58. The Court rejected the state's claim that the law was intended only to permit review in the state courts. 43 U.S.L.W. 4284, 4287 (U.S. Feb. 19, 1975).

59. The Court found that respondent was "in custody" within the meaning of 28 U.S.C. § 2241 (1970), had alleged that his custody was in violation of the laws of the United States, and had presented his federal claims to the state courts on direct appeal thus satisfying the exhaustion requirement. *Id.* at 4287 n.8.

60. The Court termed the New York provisions "commendable efforts to relieve the problem of congested trial calendars . . . ." *Id.* at 4287.

61. Chief Justice Burger and Justice Rehnquist joined in the dissent.

ciples announced in the *Brady* trilogy and affirmed in *Tollett*, respondent's voluntary and intelligent guilty plea foreclosed collateral attack upon his conviction.[62] According to White, the New York legislature's decision to allow post-guilty plea appeals of certain constitutional issues in the state courts could not alter substantive federal constitutional law. Rejecting the argument that the prior decisions were based on the concept of waiver, the dissent stated that "a guilty plea for federal purposes is a judicial admission of guilt conclusively establishing a defendant's factual guilt."[63] Moreover, the dissent asserted that the availability of federal habeas corpus relief is controlled by federal law, not state law, and thus the Court should adhere to its *Tollett* holding that after a guilty plea has been accepted, the only ground upon which habeas corpus relief may be granted is a showing that the plea was not voluntarily and knowingly entered.[64]

IV. COMMENT

The instant decision creates a significant exception to the rationale enunciated in the *Brady* and *Tollett* cases. It marks a retreat from the position under previous federal criminal law that, regardless of the circumstances, a guilty plea automatically and irrevocably waives the defendant's rights to appellate review of his constitutional challenges. Although distinguishable because based on New York's unusual statutory scheme, the decision indicates the Court's willinguess to abandon its highly formalistic treatment of guilty pleas when dealing with state statutes that make important substantive changes in the expectations of defendants concerning the opportunity of future appellate review of alleged constitutional errors. While creating an exception to the *Brady* and *Tollett* rationale,[65] the result in the instant case is consistent with what seems to be the unarticulated purpose underlying those decisions—maintaining the integrity of the plea bargaining system.[66]

62. The dissent argued that the majority opinion rested upon the faulty premise that in *McMann* and *Tollett* the Court had refused to hear the antecedent constitutional claims because the defendants had by-passed these claims with a guilty plea. Justice White stated that by-pass was not the basis of those cases; rather it was the defendants' conclusive admission of guilt that barred subsequent attack. 43 U.S.L.W. at 4288.

63. *Id.* at 4289.

64. Justice Powell, joined by Chief Justice Burger and Justice Rehnquist, wrote a separate dissent based on the reasons set forth in his concurring opinion in Schneckloth v. Bustamonte, 412 U.S. 218, 250 (1973).

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

66. Although the concept of plea bargaining may be offensive to some, it is a practical necessity and has been approved explicitly by the Supreme Court. In Santobello v. New York, 404 U.S. 257 (1971), the Court stated that "[p]roperly administered . . . [plea bargaining]

Plea bargaining is an essential ingredient of our criminal justice system, for without it the courts would be heavily burdened by the increased caseload.[67] Although currently more than ninety per cent[68] of all criminal cases are disposed of by guilty pleas, dockets are crowded and long delays are common. If more defendants who were guilty of the crimes with which they were charged could be encouraged to plead guilty without being forced to sacrifice their constitutional challenges, the burden on the courts would be eased and the trial process would be limited to cases in which there are genuine disputes to be decided.[69] To be effective, however, a completed plea bargain must be a final stopping place, and not a point of departure.[70] The *McMann* and *Tollett* rationale indicates the Court's belief that once a defendant has accepted the benefits of such negotiations, whatever they may be, he should not be free subsequently to attack the conviction; if he voluntarily and knowingly made an agreement, he should be held to it.[71] In the vast majority of states, when a defendant accepts a bargain, the state has a legitimate expectation that the resulting conviction will be final; this is one of the elements for which the state has bargained. Under these conditions, the rigid and formalistic effect given the guilty plea under the *McMann* and *Tollett* decisions is justifiable. New York and California, however, sought to make the choice of pleading guilty more attractive by providing for a statutory post-guilty plea appeal procedure that does not force a defendant to choose between going to trial or sacrificing his constitutional claims. Under these statutes, all parties realize that in exchange for relinquishment of his right to a jury trial, the defendant's right to seek further review of his consti-

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is to be encouraged." *Id.* at 260.

67. "The truth is, that a criminal court can operate only by inducing the great mass of actually guilty defendants to plead guilty, paying in leniency the price for the pleas." H. LUMMUS, THE TRIAL JUDGE 46 (1937). For arguments supporting the complete abolition of all plea bargaining see NATIONAL ADVISORY COMMISSION ON CRIMINAL JUSTICE STANDARDS AND GOALS—TASK FORCE ON COURTS 46-49 (1973).

68. D. NEWMAN, CONVICTION, THE DETERMINATION OF GUILT OR INNOCENCE WITHOUT TRIAL 3 (1966); ABA PROJECT ON MINIMUM STANDARDS FOR CRIMINAL JUSTICE: STANDARDS RELATING TO PLEAS OF GUILTY 1-2 (Approved Draft 1968) [hereinafter cited as ABA STANDARDS].

69. ABA STANDARDS, *supra* note 68, at 2.

70. Petitions for habeas corpus filed by state prisoners in District Court climbed from 1,020 in 1961, to 7,949 in 1972, an increase of more than 679%. U.S. DEP'T OF JUSTICE, SOURCEBOOK OF CRIMINAL JUSTICE STATISTICS 1973, at 299.

71. While most decisions have dealt with cases in which the defendant was attempting to avoid his obligations, a recent decision, Santobello v. New York, 404 U.S. 257 (1971), indicates the Court's determination to hold the state to its bargain also. The Court granted certiorari and reversed a conviction based on a guilty plea when, due to a change of personnel in the prosecutor's office, a sentence recommendation was made that was in excess of that previously agreed upon.

tutional challenges is preserved. In view of the essentially procedural function of the plea in this situation, the Court was justified in refusing to give it the binding effect dictated by the earlier cases. The instant decision insures that a defendant who chooses to utilize this procedure will be provided with full appellate and habeas corpus reviews with access to both the state and federal courts, and thus maintains the attractiveness and usefulness of this state procedure. Although currently in force only in New York and California, this type of appeal procedure seems to be an effective and easily implemented reform that other states could employ to mitigate the problem of docket congestion by further encouraging plea bargaining. If additional states adopt similar provisions, the instant case will insure that the defendant's constitutional challenges will receive the fullest measure of both state and federal review.

CHARLES K. CAMPBELL, JR.

Constitutional Law—Procedural Due Process—Georgia Prejudgment Garnishment Statute Violates Due Process Clause of the Fourteenth Amendment by Failing to Provide Necessary Procedural Safeguards in the Absence of Prior Notice and Hearing.

I. FACTS AND HOLDING

Plaintiff corporation, seller of goods, filed suit against defendant corporation, purchaser, for an amount owing on open account and simultaneously sought a writ of garnishment against defendant's bank account.[1] Pursuant to the Georgia garnishment statute,[2] the clerk of the trial court issued a writ of garnishment after respondent posted bond and filed an affidavit stating the amount of the debt and asserting the belief that the debt would not be collected without the garnishment.[3] Defendant filed a motion to

1. The amount of the debt in controversy was $51,279.17. The writ of garnishment was served on the First National Bank of Dalton, Georgia, as garnishee, on the same day that plaintiff filed its complaint and defendant was served with process.

2. The relevant portion of GA. CODE ANN. § 46-101 (1974) provides:

Right to writ; wages exempt until after judgment In cases where suit shall be pending, or where judgment shall have been obtained, the plaintiff shall be entitled to the process of garnishment . . . [p]rovided, further, that nothing in this section shall be construed as abridging the right of garnishment in attachment before judgment is obtained.

3. GA. CODE ANN. § 46-102 (1974) provides in part:

Affidavit; necessity and contents. Bond The plaintiff, his agent, or attorney at law shall make affidavit before some officer authorized to issue an attachment, or the clerk of any

dismiss the writ,[4] contending that the garnishment statute violated the due process clause of the fourteenth amendment[5] because it deprived defendant of its property without notice or opportunity for a hearing. The trial court denied defendant's motion, and the Supreme Court of Georgia affirmed.[6] On certiorari, the Supreme Court of the United States *held*, reversed and remanded. In the absence of prior notice and a hearing, the Georgia statute permitting the issuance of a prejudgment writ of garnishment based on an affidavit containing only conclusory allegations and which does not require judicial supervision of the garnishment process or a prompt post-garnishment hearing violates the due process clause of the fourteenth amendment. *North Georgia Finishing, Inc. v. Di-Chem, Inc.*, 95 S. Ct. 719 (1975).

II. BACKGROUND

An extensive body of law has developed over the past half century setting forth in practical terms the meaning of "due process of law." In an early pronouncement, the Supreme Court said that no property may be taken from an individual without notice and an opportunity to be heard.[7] While this point is well settled,[8] the Court

court of record in which the said garnishment is being filed or in which the main case is filed, stating the amount claimed to be due in such action, or on such judgment, and that he has reason to apprehend the loss of the same or some part thereof unless process of garnishment shall issue, and shall give bond, with good security, in a sum at least equal to double the amount sworn to be due, payable to the defendant in the suit or judgment, as the case may be, conditioned to pay said defendant all costs and damages that he may sustain in consequence of suing out said garnishment, in the event that the plaintiff shall fail to recover in the suit, or it shall appear that the amount sworn to be due on such judgment was not due, or that the property or money sought to be garnished was not subject to process of garnishment.

4. Three days after issuance of the writ of garnishment defendant filed a bond with the court clerk, discharging the garnishee and dissolving the garnishment in accordance with GA. CODE ANN. § 46-401 (1974) which provides in part:

Dissolution of garnishment; bond; judgment on bond When garnishment shall have been issued, the defendant may dissolve such garnishment upon filing in the clerk's office of the court . . . where suit is pending or judgment was obtained, a bond with good security, payable to the plaintiff conditioned for the payment of any judgment that shall be rendered on said garnishment.

Therefore, petitioner's motion to dismiss the writ was directed toward the discharge of its bond since the bank account was no longer frozen by the writ.

5. U. S. CONST. amend. XIV, § 1 provides: "[N]or shall any State deprive any person of . . . property, without due procese of law . . . ."

6. 231 Ga. 260, 201 S.E.2d 321 (1973). Subsequent to the Georgia Supreme Court's decision, a three-judge federal court declared the same statutory provisions unconstitutional. Morrow Elec. Co. v. Cruse, 370 F. Supp. 639 (N.D. Ga. 1974).

7. "Parties whose rights are to be affected are entitled to be heard; and in order that they may enjoy that right they must first be notified. Common justice requires that no man shall be condemned in his person or property without notice and an opportunity to make his defence [sic]." Baldwin v. Hale, 68 U.S. (1 Wall.) 223, 233 (1863).

8. *See* Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950); Coe v.

has applied a flexible standard in determining what form the hearing must take,[9] requiring only that a hearing appropriate to the nature of the case[10] be given "at a meaningful time and in a meaningful manner."[11] The Court traditionally has balanced the interests of the government in summary decision-making against the interests of the property owner in retaining the use and possession of his property,[12] with the result that a hearing prior to initial taking is not imperative if the opportunity for ultimate judicial determination adequately protects the interests of the individual.[13] Using this balancing test, the Court has found prehearing deprivation of property constitutional in the seizure of assets of a financially troubled savings bank,[14] seizure of misbranded drugs[15] and contaminated food,[16] collection of taxes owed the federal government,[17] seizure in aid of the national war effort,[18] and discharge of an employee incident to the operation of a military installation.[19]

One of the most troublesome areas for the Court in applying procedural due process standards has been that of prehearing seizure of property by use of the provisional credit remedies of attachment,[20] garnishment,[21] and replevin.[22] The practice of seizing and disposing of a person's assets through one of these devices has been

Armour Fertilizer Works, 237 U.S. 413 (1915); Grannis v. Ordean, 234 U.S. 385, 394 (1914); Windsor v. McVeigh, 93 U.S. 274, 277 (1876).

9. Joint Anti-Fascist Refugee Comm. v. McGrath, 341 U.S. 123, 162 (1951).

10. Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 313 (1950).

11. Armstrong v. Manzo, 380 U.S. 545, 552 (1965).

12. Cafeteria Workers Local 473 v. McElroy, 367 U.S. 886, 895 (1961); Ewing v. Metinger & Casselberry, Inc., 339 U.S. 594, 599 (1950).

13. Phillips v. Commissioner, 283 U.S. 589, 596-97 (1931).

14. Fahey v. Mallonee, 332 U.S. 245 (1947).

15. Ewing v. Mytinger & Casselberry, Inc., 339 U.S. 594 (1950).

16. North Am. Cold Storage Co. v. Chicago, 211 U.S. 306 (1908).

17. Phillips v. Commissioner, 283 U.S. 583 (1931).

18. Yakus v. United States, 321 U.S. 414 (1944); United States v. Pfitsch, 256 U.S. 547 (1921).

19. Cafeteria Workers Local 473 v. McElroy, 367 U.S. 886 (1961).

20. " 'Attachment' is a provisional, auxiliary remedy, created by statute, whereby a creditor can obtain a contingent lien on property of the debtor, and thus have this property kept available to satisfy any judgment which he may recover against the debtor. . . ." H. OLECK, DEBTOR-CREDITOR LAW 30 (1953).

21. Garnishment is a form of attachment used to reach the assets of the debtor when they are in the hands of a third-party, to whom the order is directed. *Id.* at 31. For a comparison of attachment and garnishment, see Comment, 22 VAND L. REV. 1400, 1401-02 (1969).

22. Replevin is a remedy permitting a seller of goods to take immediate possession of the goods when the purchaser has allegedly defaulted on a conditional sales contract. Comment, 71 COLUM. L. REV. 886, 887 (1971). For a historical background, see J. COBBEY, A PRACTICAL TREATISE ON THE LAW OF REPLEVIN (1890).

common in America since the colonial period.[23] Garnishment, and the closely associated writ of attachment, were derived from the medieval remedy of "foreign attachment" that enabled the creditor to gain jurisdiction over a nonresident debtor by attaching his assets found in the hands of third persons.[24] In America, no distinction was made between the resident and nonresident debtor so that the procedure originally designed as a device to obtain jurisdiction became a provisional credit remedy.[25] A due process challenge to attachment first confronted the Supreme Court in *Ownbey v. Morgan*,[26] in which the Court upheld attachment of the property of a nonresident debtor because the procedure promoted the state purpose of obtaining jurisdiction of state courts over nonresidents. In *Coffin Brothers & Co. v. Bennett*,[27] the Court upheld summary seizure of defendant's assets to satisfy his liability to depositors of an insolvent bank of which he was a stockholder. Both *Ownbey* and *Coffin Brothers* involved strong state interests—jurisdictional vitality of state courts and protection of bank deposits—but, in *McKay v. McInnes*,[28] the Court was faced with a direct challenge to prehearing seizure, the only state interest being that of aiding creditors in the collection of debts. The Court upheld the statute, citing *Ownbey* and *Coffin Brothers* as controlling.

A due process challenge to provisional collection remedies did not come before the Supreme Court again until it decided *Sniadach v. Family Finance Corp.*[29] some forty years later.[30] In *Sniadach*, the Court invalidated a wage garnishment statute that failed to provide notice and a hearing prior to the taking of the debtor's wages. The Court recognized that mere use of property is a property interest

23. Ownbey v. Morgan, 256 U.S. 94, 104-05 (1921); Mussman & Riesenfield, *Garnishment and Bankruptcy*, 27 MINN. L. REV. 1, 9-10 (1942) [hereinafter cited as Mussman].

24. Mussman, *supra* note 23, at 8.

25. Mussman, *supra* note 23, at 10-11.

26. 256 U.S. 94 (1921).

27. 277 U.S. 29 (1928).

28. 279 U.S. 820 (1929), *aff'g per curiam* McInnes v. McKay, 127 Me. 110, 141 A. 699 (1928).

29. 395 U.S. 337 (1969).

30. The question was raised on several occasions in lower courts, with the result that the collection device was routinely upheld. *See, e.g.*, Shell Oil Co. v. Milne, 127 Vt. 249, 246 A.2d 837 (1968); Byrd v. Rector, 112 W. Va. 192, 163 S.E. 845 (1932). The constitutional objection was rebutted by a variety of reasons: interest of the creditor outweighed the interest of the debtor; the taking was only temporary in nature and therefore no hearing was required until final deprivation; creditor was seen as having an equal interest in the property; no state action, and the entrenched, traditional nature of the remedies. Note, *Procedural Due Process—The Prior Hearing Rule and the Demise of Ex Parte Remedies*, 53 B.U.L. REV. 41, 44 (1973).

worthy of constitutional protection so that even temporary deprivation without a hearing violated due process requirements. The Court also seemed to depart from the traditional balancing test,[31] establishing the presumption that a hearing is required absent extraordinary circumstances.[32] In the wake of *Sniadach*, courts and commentators were uncertain whether the *Sniadach* approach would be confined to wages and other "necessities of life,"[33] what circumstances were extraordinary enough to permit seizure,[34] and what form the required prior hearing must take.[35] Although Supreme Court cases subsequent to *Sniadach* seemed to extend its approach to other forms of property, the interest at stake in each case was arguably analogous to the sensitive individual interest embodied in wages.[36] Further confusing the situation, the Court used both "balancing of interests" language and "extraordinary circumstances" language in juxtaposition.[37] Faced with the conflicting interpretations, the Court in *Fuentes v. Shevin*,[38] a 4-3 decision, invalidated the Florida and Pennsylvania replevin statutes, holding that an individual must be given an opportunity for a hearing *before* he is deprived of any significant property right except in extraordinary situations

31. *See* Note, *Garnishment of Wages Prior to Judgment is a Denial of Due Process: The Sniadach Case and Its Implications for Related Areas of the Law*, 68 MICH. L. REV. 986, 994-98 (1970).

32. 395 U.S. at 339.

33. *Compare* Adams v. Egley, 338 F. Supp. 614 (S.D. Cal. 1972) (repossession of motor vehicles invalid); Laprease v. Raymours Furniture Co., 315 F. Supp 716 (N.D. N.Y. 1970) (procedure for repossession of household furnishings invalid); Randone v. Appellate Dept., 5 Cal. 3d 536, 488 P.2d 13, 96 Cal. Rptr. 709 (1971) (statute allowing attachment of a bank account held unconstitutional) *with* Brunswick Corp. v. J & P, Inc., 424 F.2d 100 (10th Cir. 1970) (replevin of bowling alley equipment upheld); Reeves v. Motor Contract Co., 324 F. Supp. 1011, 1016 (N.D. Ga. 1971) (wage garnishment portion of general garnishment statute invalidated without disturbing any other provisions); Wheeler v. Adams Co., 322 F. Supp. 645 (D. Md. 1971) (replevin of personal property upheld).

34. *The Supreme Court, 1968 Term* 83 HARV. L. REV. 7, 115-16 (1969).

35. Clark & Landers, *Sniadach, Fuentes, and Beyond: The Creditor Meets the Constitution*, 59 VA. L. REV. 355, 358 (1973); *The Supreme Court, 1968 Term*, 83 HARV. L. REV. 7, 115 (1969).

36. *See* Morrissey v. Brewer, 408 U.S. 471 (1972) (parole revocation); Perry v. Sindermann, 408 U.S. 593 (1972) (dismissal of tenured teacher); Bell v. Burson, 402 U.S. 535 (1971) (revocation of driver's license of one whose job depended on ability to travel); Goldberg v. Kelly, 397 U.S. 254 (1970) (termination of welfare benefits).

37. In Bell v. Burson, 402 U.S. 535 (1971), the Court discussed the weight of the state's interest in protecting an injured claimant from the possibility of an unrecoverable judgment from an uninsured motorist relative to the weight of the individual's interest in avoiding suspension of a driver's license. 402 U.S. at 540. But later in the opinion, the Court asserted, "[I]t is fundamental that except in emergency situations . . . due process requires that when a State seeks to terminate an interest such as that here involved, it must afford 'notice and opportunity for hearing appropriate to the nature of the case' *before* the termination becomes effective." 402 U.S. at 542 (emphasis by the court).

38. 407 U.S. 67 (1972).

involving compelling governmental interests. The statutes in question required as prerequisites to issuance of the writ that an affidavit alleging wrongful detention be submitted to the court clerk, that a damage bond be filed, and that opportunity for a hearing be given at the trial of the main cause of action.[39] *Fuentes* eliminated any distinction between kinds of property deserving special treatment, thus extending *Sniadach* beyond "necessities of life."[40] Also in accord with *Sniadach*, the Court ruled that even a temporary deprivation of property required a prior hearing, thus expressly rejecting the post-seizure hearing and creditor's damage bond as curative measures.[41] The Court also attempted to resolve the question of what elements are necessary to bring a seizure within the special circumstances exception to the prior hearing rule, indicating that an important governmental or general public interest must be at stake, special need for prompt action must be present, and the procedure must be under the strict control of proper governmental officials acting under narrowly drawn statutes specifying when summary action is necessary and justified.[42] The Court expressly excluded state intervention to aid private debt collection from the extraordinary circumstance classification.[43] *Fuentes* subsequently became the leading case for a new, strictly applied standard of prior notice and hearing[44] and provided the impetus for invalidation of a wide range of creditor collection devices.[45]

39. 407 U.S. at 73-78. The Pennsylvania statute did not require any hearing unless initiated hy the debtor himself.

40. 407 U.S. at 90.

41. 407 U.S. at 85-86.

42. The Court found the three prerequisites present in past cases in which summary seizure was upheld "to collect the internal revenue of the United States, to meet the needs of a national war effort, to protect against the economic disaster of a bank failure, and to protect the public from misbranded drugs and contaminated food." 407 U.S. at 91-92. Therefore, the Court explained the early due process cases which had upheld summary seizure on the basis of a balancing test as extraordinary situations obviating the necessity of prior notice and bearing. *See* notes 13-19 *supra* and accompanying text. The Court, however, was careful to exclude McKay v. McInnes from this group of cases, explaining that it "cannot stand for any more tban was established in the *Coffin Bros.* and *Ownbey* cases on which it relied completely." 407 U.S. at 91 n.23; *see* notes 26-28 *supra* and accompanying text.

43. 407 U.S. at 93. The Court hedged its position by sanctioning the use of attachment to obtain quasi in rem jurisdiction of the debtor, clearly an instance of state intervention to aid private gain, finding justification in the necessity to secure jurisdiction of state courts. 407 U.S. at 91 n. 23. *But cf.* Note, *Quasi in Rem Jurisdiction and Due Process Requirements*, 82 YALE L.J. 1023 (1973).

44. *See, e.g.*, Mitchell v. Tennessee, 351 F. Supp 846 (W.D. Tenn. 1972), in which a three-judge court expressed regret in declaring the Tennessee replevin statute unconstitutional, but indicated that the statute could not stand in the face of the rigid standard set forth in *Fuentes*.

45. *See, e.g.*, Hernandez v. European Auto Collision, Inc., 487 F.2d 378 (2d Cir. 1973) (garagemen's lien); Hall v. Garson, 468 F.2d 845 (5th Cir. 1972) (landlord's lien); Gunter v.

In *Mitchell v. W.T. Grant Co.*[46] the Supreme Court halted the evolution of the *Sniadach-Fuentes* approach to due process by upholding a Louisiana sequestration[47] statute which, like the *Fuentes* statutes, allowed the repossession of goods without prior notice and an opportunity for a hearing.[48] Justice White, writing for the majority,[49] noted that the Louisiana statute was more narrowly drawn, containing certain safeguards designed to protect the debtor's interests: the writ was issued only if the debtor might conceal, waste, or dispose of the property; the issuance was conditioned on the filing of a factual rather than conclusory affidavit; the process was subject to control by a judicial officer rather than a court clerk; and the debtor was given an immediate dissolution hearing in which the creditor was required to present proof supporting his allegations.[50] Regardless of these distinguishing characteristics, if the Court had strictly applied the test set forth in *Fuentes* the statute would have been unconstitutional since no prior opportunity for a hearing was given and the state's interest in private repossession was not a special circumstance recognized by *Fuentes*.[51] The language in *Mitchell* seemed to indicate the Court's intent to return to the early due process approach, balancing the state's interest in orderly functioning of commerce against the individual's interest in uninterrupted possession and use of the property,[52] leading five members of the

Merchants Warren Nat'l Bank, 360 F. Supp. 1085 (D. Me. 1973) (attachment of real property); Hattell v. Public Serv. Co., 350 F. Supp. 240 (D. Colo. 1972) (utility shut-offs). *See also* Clark & Landers, *Sniadach, Fuentes, and Beyond: The Creditor Meets the Constitution*, 59 VA. L. REV. 355 (1973). After *Fuentes*, the remedy of prejudgment replevin seemed dead except in three situations. First, the repossession remedy conceivably could have fit the "extraordinary situation" analysis. Secondly, the remedy of self-help under section 9-503 of the Uniform Commercial Code might have been available. For cases upholding section 9-503 on grounds that self-help involves no state action, see Nowlin v. Professional Auto Sales, Inc., 496 F.2d 16 (8th Cir. 1974); James v. Pinnix, 495 F.2d 206 (5th Cir. 1974); Shirley v. Nat'l Bank, 493 F.2d 739 (2d Cir. 1974). Thirdly, although *Fuentes* expressly condemned waiver clauses and cognovit notes in the consumer credit setting, 407 U.S. at 96, the remedies were still available in a general commercial context when the parties entering the agreement were of equal bargaining power. D. H. Overmyer Co. v. Frick Co., 405 U.S. 174 (1972); Swarb v. Lennox, 405 U.S. 191 (1972).

46. 416 U.S. 600 (1974).

47. Sequestration is the civil law equivalent of replevin.

48. According to the dissent, the statutes were "remarkably similar." 416 U.S. at 629.

49. Justice White was joined by Chief Justice Burger and Justices Blackmun, Powell, and Rehnquist. Justice Powell filed a concurring opinion.

50. 416 U.S. at 605-06.

51. *See* note 43 *supra* and accompanying text.

52. *See* notes 11 & 12 *supra* and accompanying text.

Court,[53] lower court judges,[54] and commentators[55] to conclude that *Fuentes* had been overruled to the extent that it required notice and an opportunity for a hearing prior to seizure.[56] In addition to the question whether *Fuentes* had lost all its vitality or was merely distinguished by the Court, the *Mitchell* decision raised other questions. The Court seemed to indicate that hearing and notice could be by-passed prior to seizure if certain statutory safeguards were present, but it failed to clarify completely what those safeguards must be. Additionally, because *Sniadach* was left undisturbed by the Court, the question arose whether the Court intended to distinguish certain property as "necessities of life," thus requiring application of a different due process standard.

III. The Instant Opinion

In determining whether the challenged statute met the procedural requirements of the fourteenth amendment, the instant Court[57] looked to the statutory safeguards protecting the debtor's property interest in the absence of prior notice and hearing. Comparing the instant statute to the *Fuentes* statutes, the Court asserted that the same constitutional infirmities were present. Each statute allowed the seizure of property without prior notice and opportunity for a hearing by the issuance of a writ by a court clerk after the filing of an affidavit containing conclusory allegations. The instant Court restated its belief set forth in *Sniadach* and *Fuentes* that even a temporary deprivation of property does not put the seizure beyond scrutiny under due process requirements. The Court

53. Justices Stewart, Douglas, and Marshall agreed in one dissent that *Fuentes* had been overruled. 416 U.S. at 634. Justice Brennan, in a separate dissent, agreed that *Fuentes* required reversal of *Mitchell*. 416 U.S. at 636. Justice Powell in an opinion concurring with the majority also said *Fuentes* was overruled. 416 U.S. at 623.

54. Ruocco v. Brinker, 380 F. Supp. 432, 436 (S.D. Fla. 1974) (three-judge court). *But see* Woods v. Tennessee, 378 F. Supp. 1364, 1365 (W.D. Tenn. 1974) (indicating that *Fuentes* may be applicable if the challenged statute is substantially similar to the statutes in *Fuentes*).

55. *The Supreme Court, 1973 Term*, 88 Harv. L. Rev. 41, 71-72 (1974); Note, *Mitchell v. W. T. Grant—The Repossession of Fuentes*, 5 Memphis St. L. Rev. 74, 87 (1974).

56. A distinguishing feature of *Mitchell* is that Louisiana law provides that a vendor-creditor loses his security interest in the property when the debtor alienates the property. In all other states the Uniform Commercial Code is in effect and protects the perfected security interest against the interests of third-party purchasers. Uniform Commercial Code § 9-201; J. White & R. Summers, Handbook of the Law Under the Uniform Commercial Code § 25-2, at 901 (1972). Although individuals buying consumer goods for their own use take free of any security interest of the seller, the seller can protect himself by the prior filing of a financing statement. Uniform Commercial Code § 9-307(2); J. White & R. Summers, *supra* § 25-14, at 943-44. Therefore, the Louisiana situation may have been peculiar enough in the eyes of the Court to merit special treatment, but the Court did not indicate that it subscribed to this approach apparently viewing it as only one factor of many that must be considered.

57. Justice White wrote the majority opinion as he did in *Mitchell*. He was joined in the instant case by Justices Brennan, Douglas, Stewart, and Marshall, the four dissenters in *Mitchell*.

then asserted that the Georgia statute had none of the saving characteristics of the Louisiana sequestration statute upheld in *Mitchell*. According to the Court, the *Mitchell* statute survived challenge because of the presence of safeguards which imposed judicial control over the process of issuance of the writ; required the creditor's affidavit to contain factual allegations; and provided for an immediate post-seizure hearing at which the debtor could seek dissolution of the writ. The Court also pointed out that it would not distinguish kinds of property requiring special protection, subjecting garnishment of a bank account in a commercial setting involving two corporations of equal bargaining power to the same standard applied to individual property in a consumer setting. Since the Georgia statute did not require prior notice and hearing and failed to properly accommodate the interests of the debtor by other safeguards, the Court held the statute to be in violation of the due process clause of the fourteenth amendment.[58]

In a dissenting opinion, Justice Blackmun[59] argued that the Court's decision could not be supported by *Sniadach* or *Fuentes* and that the statute was not unconstitutional under the *Mitchell* standard. Asserting that *Sniadach* was applicable only to wages, he said that it should not be expanded to arms-length transactions between financially sound corporations. Citing the dissent and the Powell concurrence in *Mitchell*, he contended that the *Fuentes* decision had been overruled and thus should have no application in the instant case. Blackmun bolstered his argument by contending that *Fuentes* had been a weak precedent from its inception because it was the decision of a 4-3 majority. Turning to the *Mitchell* balancing test, the dissent found sufficient statutory safeguards in the requirement that suit be filed before process issues, thus insuring an ultimate hearing; that double bond be posted to cover damages; and that the creditor file an affidavit of apprehension of loss. The dissent cast aside the clerk-judge distinction as being of little significance, and found that, in a commercial setting, the interests of the debtor were properly protected so that the failure to give prior notice and hearing did not violate the due process clause.[60]

58. Justice Powell filed a concurring opinion in which he reasserted his belief, set forth in *Mitchell*, that *Fuentes* had been overruled. He applied the balancing test of *Mitchell* and found the Georgia statute unconstitutional primarily because of the failure of the statute to provide a prompt dissolution hearing. He said that presence of a judicial officer should not be a prerequisite to constitutionality.

59. Justice Blackmun was joined in dissent by Justice Rehnquist. Chief Justice Burger filed a separate dissent in which he concurred with Blackmun that *Sniadach* should not be applied in a commercial context between corporations and that the clerk-judge distinction is of little significance.

60. The dissenting judges also expressed regret at what they believed to be a movement by the Court to embark on a case-by-case analysis of state statutes in the field of creditor collection remedies.

IV. COMMENT

The instant decision resolves some of the confusion engendered by *Mitchell* but leaves other questions unanswered. In direct contrast to *Fuentes*, *Mitchell* indicated that some property interests, "necessities of life," are more substantial than others and deserve special protection.[61] The instant Court resolved the issue in favor of the *Fuentes* approach,[62] stating that once a property interest is found, the Court will not engage its own subjective viewpoint to determine the relative importance of the interest.[63] In the instant case, the Court was presented with a factual situation in which the property interest at stake could have been distinguished easily from those interests involved in *Sniadach*, *Fuentes*, and *Mitchell*. The deprivation occasioned by seizure of the debtor corporation's bank account produced slight possibility of human suffering and seemed to produce very little inconvenience since the writ was dissolved within three days by posting a bond,[64] a transaction "of a day-to-day type in the commercial world."[65] The refusal of the Court to make the distinction in this particular case, in which the interest was clearly not vital or necessary to human life and in which such a distinction might not have produced a grossly unreasonable result, seems to indicate a firm commitment by the members of the majority to a single standard of review applicable to all property interests.[66] By returning to the *Fuentes* rationale, the Court promotes a workable rule which avoids reliance on each judge's subjective opinion of what property interests are important enough to be classified as "necessities of life," thus promoting certainty and uniformity in subsequent decisions.

A second question seemingly answered by the instant Court, despite some confusing language,[67] is the extent to which *Fuentes*

61. 416 U.S. at 614.

62. 407 U.S. at 89-90.

63. 95 S. Ct. at 723.

64. *See* note 3 *supra*.

65. 95 S. Ct. at 729 (dissenting opinion).

66. The Court, however, has been willing to differentiate between property interests in the case of cognovit notes and waiver clauses in which the debtor waives his right to a hearing when the note is made. In D.H. Overmyer Co. v. Frick Co., 405 U.S. 174 (1972), the Court upheld waiver clauses in an arm's-length transaction between corporations of equal bargaining power. But in Swarb v. Lennox, 405 U.S. 191 (1972), the Court invalidated a confession of judgment clause in a consumer credit transaction, noting the possible presence of adhesion contracts and overreaching by creditors. *See also* Fuentes v. Shevin, 407 U.S. 67, 94-96 (1972).

67. The majority opinion in *Di-Chem* cited *Fuentes* with approval, but all the members of the majority except Justice White had said in *Mitchell* that *Fuentes* had been overruled. *See* note 54 *supra*. The *Mitchell* majority distinguished *Fuentes* but two of the same justices writing in *Di-Chem* said *Mitchell* had overruled it. *See* note 60 *supra* and accompanying text.

retains its precedential value. Although the Court relied on the factual and statutory setting of *Fuentes*, the test of constitutionality applied in the instant case was not the same rigid standard set forth by the *Fuentes* Court. *Fuentes* held that due process requires "that an individual be given an opportunity for a hearing *before* he is deprived of any significant property interest, *except for extraordinary situations* where some valid governmental interest is at stake that justifies postponing the hearing until after the event."[68] Justice White, writing for the *Di-Chem* Court, stated that the statute in *Fuentes* and the instant statute were unconstitutional "because the official seizures had been carried out without notice and without opportunity for a hearing *or other safeguard* against mistaken repossession."[69] Justice White's standard is weaker than the presumption established by *Fuentes* and is designed to achieve an accommodation of interests in the vein of early due process and the standard set forth by Justice White in *Mitchell*. Therefore, it appears that *Fuentes* has been overruled to the extent that it required notice and a hearing prior to deprivation of a property interest.[70] Conceptually, the balancing test which has replaced *Fuentes* goes one step further toward allowing summary seizure than the pre-*Sniadach* balancing test. The early due process cases involved an accommodation of private property interests vis-à-vis the public welfare,[71] but the test evolving from *Mitchell* and *Di-Chem* equates the creditor's interest in debt collection with the public welfare for purposes of the balancing analysis.[72] The result may be an undesirable extension of the pre-*Sniadach* rationale, particularly in light of the fact that creditor collection devices do little to promote public welfare when abused by creditors as instruments of oppression.[73] In a practical sense, the shift to a balancing test means that counsel for an individual who has been deprived of a property interest by summary seizure can no

68. 407 U.S. at 82 (emphasis added).

69. 95 S. Ct. at 722 (emphasis added).

70. For cases reaching the same conclusion on the basis of the *Mitchell* decision see Turner v. Impala Motors, 503 F.2d 607 (6th Cir. 1974) (dicta); Ruocco v. Brinker, 380 F. Supp. 432 (S.D. Fla. 1974).

71. *See* notes 13-19 *supra* and accompanying text.

72. It may be argued that *Mitchell* is a peculiar situation requiring zealous protection of creditor interests due to the absence of the statutory protection afforded by the Uniform Commercial Code in other states. *See* note 56 *supra*. At least two lower courts, however, have relied on *Mitchell* to uphold replevin statutes in states where the UCC is in effect, protecting the secured creditor against destruction of his security interest through alienation by the debtor. Guzman v. Western State Bank, 381 F. Supp. 1262 (D.N.D. 1974); Woods v. Tennessee, 378 F. Supp. 1364 (W.D. Tenn. 1974).

73. *See* Patterson, *Forward: Wage Garnishment an Extraordinary Remedy Run Amuck*, 43 WASH. L. REV. 735 (1968); Note, *Garnishment in Kentucky—Some Defects*, 45 KY. L.J. 322 (1956).

longer unequivocally assert that due process mandates opportunity for a prior hearing. He must look to the facts of his client's case and direct the court to those aspects of the taking which appear to be most inequitable. In an example of this type approach, *Arnett v. Kennedy*,[74] the Court upheld the discharge of a nonprobationary employee although no opportunity for prior hearing was given. At least three judges found a constitutional entitlement[75] but stated that due process is satisfied if the hearing occurs after suspension but before final termination. The Court, in an opinion handed down the same week as *Di-Chem*, referred to extraordinary circumstances, but allowed the *ex parte* seizure of a yacht to stand even though the owner did not know of the seizure until the statutory period for contest had passed.[76] In both cases the Court evidenced a perceptible movement away from the rigidity of *Fuentes* to a flexible position allowing accommodation of all interests concerned.

After establishing a flexible balancing standard, the instant Court failed to explore fully the effectiveness of the safeguards set forth and to resolve completely what safeguards are necessary when a prior hearing is not given. The effectiveness of judicial scrutiny has been questioned by one commentator,[77] who observed that judicial supervision in Louisiana under the *Mitchell* statute appears to be purely ministerial once the affidavit is filed, indicating that the supervision is actually an undemanding check on potential abuses of the debtor's rights. One way effectively to implement judicial scrutiny would be to require the same type showing necessary to secure a preliminary injunction or temporary restraining order,[78] but the sheer volume of cases would pose formidable practical problems. Factual affidavits may serve to deter the filing of fraudulent or spurious affidavits, but the deterrence is lost if the affiant is not promptly put to his proof. Properly administered, the post-seizure hearing may be the most effective device to prevent injustice, but the danger lies in its undue postponement. As an illustration of the possible illusory nature of the protection, the dissent in the instant

74. 416 U.S. 134 (1974).

75. Three judges found a statutorily based entitlement and held that retention of the entitlement was conditioned upon the statutory procedures for withdrawing the grant. *See The Supreme Court, 1973 Term, supra* note 55, at 83.

76. Calero-Toledo v. Pearson Yacht Leasing Co., 416 U.S. 663 (1974). The Court's holding may be explained by the need to assert in rem jurisdiction over the property in order to conduct forfeiture proceedings.

77. *The Supreme Court, 1973 Term, supra* note 55, at 79-80.

78. *See* Garner v. Tri-State Development Co., 382 F. Supp. 377 (E.D. Mich. 1974) (court compares the statutory scheme in *Mitchell* to the procedure in federal court for issuance of an *ex parte* restraining order).

case was willing to let the trial on the merits suffice as a post-seizure hearing,[79] even though the trial might not occur for several months. This kind of delay flies in the face of the Court's assertion that use and possession of property is itself a property interest worthy of protection. From a reading of the instant opinion it is impossible to determine the relative importance of the factors to the Court. The lower court cases following *Mitchell* exhibit varying interpretations of the weighting of safeguards. The Tennessee replevin statute was upheld despite the fact that the statute makes no provision for an immediate post-seizure hearing.[80] The North Dakota replevin statute was allowed to stand even though it contains no provision for judicial supervision.[81] In both cases the courts found that the presence of other safeguards compensated for the omissions. The lower courts in reaching their decisions to uphold or invalidate a statute under *Mitchell* usually have employed the same approach as the instant Court, comparing the challenged statute to the *Fuentes* statutes and to the *Mitchell* statute.[82] The effect is to establish a continuum with *Mitchell* and *Fuentes* at either end and the challenged statute in the middle. Whether the presiding court sees the statute as falling closer to *Fuentes* or closer to *Mitchell* will probably depend on each judge's subjective feeling about the use of creditor remedies in general and the specific factual situations before the court. The instant opinion does little to remedy this state of affairs. The Court's movement to a flexible standard is more in keeping with traditional practice and provides an analytical device for considering and accommodating both creditor and debtor interests, but the Court's failure fully to formulate meaningful safeguards and to elaborate on their interaction contributes to confusion and subjectivity. In *Morrissey v. Brewer*[83] the Court set forth the minimum standards acceptable before parole could be revoked. A similar effort should be made in the area of creditors' remedies so that flexibility can be achieved without promoting uncertainty and subjective decision-making.

KEITH B. SIMMONS

79. 95 S. Ct. at 729.

80. Woods v. Tennessee, 378 F. Supp. 1364 (W.D. Tenn. 1974).

81. Guzman v. Western State Bank, 381 F. Supp. 1262 (D.N.D. 1974).

82. *See* Garner v. Tri-State Development Co., 382 F. Supp. 377 (E.D. Mich 1974); Manning v. Palmer, 381 F. Supp. 713 (D. Ariz. 1974); Garcia v. Krausse, 380 F. Supp. 1254 (S.D. Tex. 1974).

83. 408 U.S. 471, 488-89 (1972).

Taxation—Accumulated Earnings Tax—Decrease in Accumulated Earnings and Profits in a Taxable Year Because of Redemptions of Stock from Tax-Exempt Charities does not Preclude Imposition of the Accumulated Earnings Tax

I. Facts and Holding

In 1959 the president and sole shareholder of taxpayer corporation began a practice of contributing his taxpayer stock to certain tax-exempt charities and taking corresponding charitable deductions.[1] Taxpayer had substantial income in each subsequent year[2] and on several occasions redeemed portions of the donated stock although it never compensated its president for his services and paid only two relatively small cash dividends.[3] In 1968 taxpayer redeemed the last of its stock held by the charities, causing a decrease for the year in its accumulated earnings and profits despite substantial taxable income.[4] The Commissioner of Internal Revenue assessed accumulated earnings tax deficiencies for 1967 and 1968,[5] contending that in both years taxpayer had been availed of for the purpose of avoiding income tax with respect to its principal shareholder by permitting its earnings and profits to accumulate instead of being divided or distributed within the meaning of section 532(a) of the Internal Revenue Code.[6] Challenging these deficiencies, tax-

1. Taxpayer is a closely held corporation incorporated in 1954 under the laws of Michigan. Its business is selling and distributing automobile parts in Michigan and Ohio. Taxpayer's president, Emmet E. Tracy, and his wife, between 1959 and 1967, donated 7,190 shares of stock in taxpayer to 4 charities, Catholic Foreign Mission, St. Mary's Church, Jesuit Seminary Guild, and Guest House, taking charitable deductions totalling $728,325.

2. Taxpayer's income ranged from $159,879 ($82,343 after taxes) in 1959 to $596,609 ($278,783 after taxes) in 1968.

3. Taxpayer paid cash dividends of $46,300 in 1967 and $67,440 in 1968. In addition, in December 1968, taxpayer's board of directors voted Tracy, then sole shareholder, a stock dividend of 5000 shares of recently authorized one-dollar par 7-dollar cumulative preferred stock.

4. Taxpayer in 1968 expended $434,460 to redeem 1820 shares of its stock. Of this expenditure $1,820 was chargeable to capital account, and $432,640 to earnings and profits. Had these funds been retained, taxpayer's accumulated earnings and profits would have increased in 1968 from $1,582,390.05 to $1,793,739.08.

5. Pursuant to § 534(b) of the Internal Revenue Code of 1954, the Commissioner notified taxpayer on November 10, 1970, of proposed deficiencies for 1967 and 1968. Taxpayer did not file a responding statement to challenge the proposed deficiencies, as permitted by § 534(c). On April 14, 1971, a notice of deficiency was mailed to taxpayer assessing deficiencies of $79,419.93 and $84,593.87 for 1967 and 1968, respectively.

6. The accumulated earnings tax applies to every corporation, with certain exceptions, formed or availed of for the purpose of avoiding the income tax with respect to its shareholders or the shareholders of any other corporation, by permitting earnings and profits to accumulate instead of being divided or distributed. Int. Rev. Code of 1954, § 532(a).

payer maintained that the decrease in its accumulated earnings and profits in 1968 took it outside the meaning of section 532(a) and therefore made the accumulated earnings tax inapplicable in that year. Though finding taxpayer liable for 1967, the United States Tax Court accepted taxpayer's contention for 1968 and expunged the second deficiency.[7] On appeal by the Commissioner to the United States Circuit Court of Appeals for the Sixth Circuit, *held*, reversed and remanded for further findings of fact. A decrease in accumulated earnings and profits in a taxable year because of redemptions of stock from tax-exempt charities does not preclude a finding that a corporation was availed of in that year for the purpose of avoiding income tax with respect to its shareholders by permitting earnings and profits to accumulate instead of being divided or distributed within the meaning of section 532(a) of the Internal Revenue Code. *GPD, Inc. v. Commissioner*, 35 Am. Fed. Tax R.2d 75-348 (6th Cir. 1974).

II. Background

The accumulated earnings tax originated in the Tariff Act of 1913,[8] which required shareholders to include in taxable income their entire distributive share of the gains and profits of all corporations formed or fraudulently availed of for the purpose of avoiding additional income tax through the medium of permitting these gains and profits to accumulate rather than being divided or distributed. Doubting the constitutionality of requiring partnership treatment of shareholders,[9] Congress in 1921 substituted an income surtax on these corporations that contained an option under which shareholders might exempt a corporation by electing to have all its net income taxed to them.[10] The Revenue Act of 1934 for the first time allowed corporations to deduct from their income, for purposes of the penalty tax, amounts actually paid out in dividends to shareholders, while retaining the shareholders' election to report the corporation's entire net income pro rata as their own.[11] The 1938 Act revised the shareholder election provision into a consent dividend procedure allowing shareholders to report amounts as dividends,

7. GPD, Inc. v. Commissioner, 60 T.C. 480 (1973).

8. Tariff Act of 1913, § II(A)(2), 38 Stat. 166.

9. H.R. Rep. No. 350, 67th Cong., 1st Sess. 12-13 (1921); S. Rep. No. 275, 67th Cong., 1st Sess. 16-17 (1921). The source of these douhts was the Supreme Court's decision in Eisner v. Macomber, 252 U.S. 189 (1920).

10. Revenue Act of 1921, § 220, 42 Stat. 247. The shareholder election was eliminated in 1924, but reinstated in 1926. Revenue Act of 1924, § 220, 43 Stat. 277; Revenue Act of 1926, § 220(e), 44 Stat. 34.

11. Revenue Act of 1934, § 102, 48 Stat. 702.

which would increase the dividends-paid deduction to the extent amounts were reported pro rata, without requiring actual payment.[12] The present Internal Revenue Code essentially retains the 1938 provisions by imposing in each taxable year an additional tax on the accumulated taxable income of every corporation "formed or availed of for the purpose of avoiding income tax with respect to its shareholders . . . by permitting earnings and profits to accumulate instead of being divided or distributed,"[13] and by reducing accumulated taxable income for all nonpreferential dividends and distributions, including consent dividends.[14]

Thus, the basic operative phrase "formed or availed of for the purpose of avoiding income tax by permitting earnings and profits to accumulate instead of being divided or distributed" has not been changed significantly since the first federal income tax statute following the passage of the sixteenth amendment. Neither the statutory provisions nor the congressional reports have indicated expressly whether application of the tax requires accumulation within the taxable year.[15] Enactment of the 1928 House Bill, which substituted the phrase "to remain accumulated," might have resolved this question, but the Senate reverted to the previous wording which was reenacted.[16] Congress has used the phrase "earnings and profits for the taxable year" in defining the accumulated earnings credit,[17] and the accompanying Senate Report indicates that prior accumulations must be considered in determining whether a corporation needed to retain its current earnings,[18] but the basic operative phrase has remained unaltered in this respect. Further complications result from the use of "accumulated taxable income" as a measure for the tax, in contrast to the use of "earnings and profits" in the operative phrase, which determines the application of the tax.

12. Revenue Act of 1938, §§ 27(b)(1), 28(c), 102(d)(2), 52 Stat. 468, 471, 483.

13. INT. REV. CODE OF 1954, §§ 531, 532.

14. When applicable, the tax is levied by § 531 at the rate of 27.5% of the first $100,000 of "accumulated taxable income" and at the rate of 38.5% of any "accumulated taxable income" above $100,000. The term "accumulated taxable income," defined in § 535 means the corporation's taxable income for the year in question (with certain adjustments), minus the sum of the dividends-paid deduction and the "accumulated earnings credit." The deduction for dividends paid is allowed in § 561. Section 562(c) disqualifies disproportionate distributions, and § 565 provides the consent dividend procedure.

15. *See generally* J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861 (1938).

16. *See* H.R. REP. No. 2, 70th Cong., 1st Sess. 17, 18 (1928); S. REP. No. 960, 70th Cong., 1st Sess. 12, 25 (1928); Revenue Act of 1928, § 104(a), 45 Stat. 814.

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

18. S. REP. No. 1622, 83d Cong., 2d Sess. 317 (1954).

The Code does not comprehensively define "earnings and profits," although it does use the concept for a variety of purposes, especially in determining the tax effect upon shareholders of corporate distributions.[19] Because a disproportionate distribution in redemption of stock is chargeable against earnings and profits[20] but does not reduce "accumulated taxable income," the measure of the penalty tax may be high while the accumulated earnings have not increased at all during the year under scrutiny. With these complications inherent in the statutory scheme, courts have inevitably been called upon to determine the conditions necessary for application of the accumulated earnings tax in a particular year.

Although no court has explicitly decided the issue, some courts have indicated that a corporation "formed" for the proscribed purpose of avoiding income tax with respect to its shareholders is liable for the accumulated earnings tax in every subsequent year.[21] On the other hand, some courts have held, without discussion, that a judgment that a corporation was "availed of" in one year does not bar, either by estoppel or res judicata, a challenge to an assessment for a later year.[22] Thus if the corporation was not formed for tax avoidance purposes, liability for the penalty tax in a particular year depends on whether it was availed of for the proscribed purpose in that year. Some cases lend support to the proposition that neither successful tax avoidance[23] nor an accumulation in excess of the needs of the business[24] is necessary to imposition of the tax. Nonetheless, *W. S. Farish & Co. v. Commissioner*,[25] which involved a corporation

19. The following Code provisions involve earnings and profits: § 333 (one-month liquidations); § 1371 (Subchapter S corporations); § 951 (controlled foreign corporations); § 902 (deemed-paid foreign tax credit); and § 1248 (stock of a controlled foreign corporation). *See* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 7.03 (abr. stud. ed. 1971).

20. *See* B. BITTKER & J. EUSTICE, *supra* note 19, ¶ 9.65; Herwitz, *Stock Redemptions and the Accumulated Earnings Tax*, 74 HARV. L. REV. 866, 932 nn.171 & 172 (1961).

21. A.D. Saenger, Inc. v. Commissioner, 84 F.2d 23, 24 (5th Cir. 1936), *aff'g* 33 B.T.A. 135 (1935) (formed and availed of); Rands, Inc. v. Commissioner, 34 B.T.A. 1094, 1097 (1936) (formed and availed of).

22. World Publishing Co. v. United States, 104 F. Supp. 784, 787 (N.D. Okla. 1952); United Business Corp. of America v. Commissioner, 33 B.T.A. 83, 87-88 (1935) (tax imposed, nevertheless; taxpayer availed of in year in question).

23. A.D. Saenger, Inc. v. Commissioner, 84 F.2d 23, 24 (5th Cir. 1936), *aff'g* 33 B.T.A. 135 (1935). *See* Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code*, 49 YALE L.J. 171, 184 (1939).

24. United Business Corp. of America v. Commissioner, 62 F.2d 754, 755 (2d Cir.), *cert. denied*, 290 U.S. 635 (1933), *aff'g* 19 B.T.A. 809, 828 (1930); Pelton Steel Casting Co. v. Commissioner, 28 T.C. 153, 173 (1957), *aff'd*, 251 F.2d 278 (7th Cir.), *cert. denied*, 356 U.S. 958 (1958); Trico Products Corp. v. Commissioner, 46 B.T.A. 346, 374 (1942), *aff'd*, 137 F.2d 424 (2d Cir. 1943); *see* Rudick, *supra* note 23, at 184.

25. 38 B.T.A. 150 (1938).

formed in 1929 to avoid tax by registering losses, established that a purpose to avoid tax by some means that does not involve accumulation is not sufficient for liability.[26] The Commissioner, having lost on this initial issue in *Farish*, also contended that the company had recouped all its losses of earlier years and that it had been "availed of" in 1934 by permitting its gains and profits to accumulate. Disagreeing with the Commissioner's calculation, the Board of Tax Appeals held that the company still had a cumulative operating deficit instead of distributable gains and profits. The Board went on to state that, in this situation, the company could not have been availed of for the prohibited purpose, although the Commissioner weakened the precedential value of the Board's statement by substantially conceding this point. The Board further found that the company had insufficient funds for its business, and the Fifth Circuit in affirming apparently relied on this finding.[27]

The Board next commented on the meaning of "availed of" in *Corporate Investment Co. v. Commissioner*,[28] in which the Commissioner again contended that a corporation was liable in one year because it had been "availed of" in prior years. In rejecting this argument, the Board stated that Congress intended to apply the tax to a corporation "availed of" within the taxable year by permitting gains and profits of that year to accumulate, but did not intend to tax a corporation because it had been "availed of" in other years or because it did not distribute a surplus accumulated in prior years. The Board based its reasoning on the principles of annual accounting, the use in the statute of the words "to accumulate" instead of "to remain accumulated,"[29] the use of current income to measure the tax, and the exemption from the tax of any corporation whose current earnings were distributed to or reported by its shareholders. The Board ultimately exonerated the corporation because, although current gains were present, the proscribed purpose of avoiding taxation was absent.

Finally in *American Metal Products Corp. v. Commissioner*,[30] a court considered a corporation with both accumulated taxable income and accumulated earnings and profits, but no increase in accumulated earnings during the taxable year. Relying on statements in *Farish* and *Corporate Investment Co.* indicating that each

26. *See* Rudick, *supra* note 23, at 188-89.

27. 104 F.2d 833 (5th Cir. 1939).

28. 40 B.T.A. 1156 (1939).

29. The Board referred to the legislative history of the 1928 Act. *See* note 16 *supra* and accompanying text.

30. 34 T.C. 89 (1960), *aff'd sub nom.* Adler Metal Products Corp. v. Commissioner, 287 F.2d 860 (8th Cir. 1961) (appeal by taxpayer concerning 1952 and 1954).

year must be considered separately and that the proscribed act is the accumulation of "gains and profits," not "taxable net income," the Tax Court held, on its own motion, that the accumulated earnings tax did not apply to the taxpayer corporation in 1953 because its earned surplus declined in that year.[31] A similar situation arose in *Ostendorf-Morris Co. v. United States*,[32] in which a preferential stock redemption had wiped out the company's current earnings but not its accumulated taxable income. Focusing on the pro rata requirement of the dividends-paid deduction, the district court stressed that because Congress did not allow a preferential redemption to reduce accumulated taxable income, it would be inconsistent to permit this type of redemption to accomplish the same result indirectly by making the tax inapplicable. The court then outlined two unreasonable results that the taxpayer's position would have allowed. First, the difference between one cent of current earnings and zero current earnings could have resulted in a difference of thousands of dollars of tax liability. Secondly, if a corporation had accumulated earnings to finance a redemption reasonably needed by its business and used the funds for that purpose in the same year, the transaction would not have affected liability in a future year; but by merely postponing the redemption until the next year, the corporation could have precluded liability in that year also if the amount expended in redemption exceeded the later year's earnings. Declaring that Congress could not have contemplated these results, the court upheld the assessment and expressly refused to follow the Tax Court's holding in *American Metal Products*.

III. The Instant Opinion

The instant court foreshadowed its holding by pointing out that Congress intended that the accumulated earnings tax compel companies with unneeded profits to make distributions upon which their shareholders would incur taxation.[33] After setting forth the position of the Tax Court by quoting extensively from its opinion,[34] which relied on *Farish*, *Corporate Investment Co.*, and *American Metal Products*, the instant court refrained from further mention of these cases. Next the court distinguished "earnings and profits" from "taxable income", characterizing "earnings and profits" as a

31. That this decline was the sole basis for the decision as to 1953 seems clear from the imposition of the penalty on the same corperation in both 1952 and 1954. *Id.*

32. 26 Am. Fed. Tax R.2d 70-5369 (N.D. Ohio 1968).

33. The court quoted from United States v. Donruss Co., 393 U.S. 297, 303 (1969) (quoting Helvering v. Chicago Stock Yards Co., 318 U.S. 693, 699 (1943)).

34. GPD, Inc. v. Commissioner, 60 T.C. 480, 489-92 (1973).

broader concept not rigidly defined in the Code, but designed to reflect a corporation's capacity to pass along tax consequences to its shareholders through distributions to them.[35] Then, beginning a thorough analysis of the legislative history of the accumulated earnings tax, the court quoted the 1913 provision[36] and some associated floor debate,[37] which included the opinion of one senator that the wording would allow review of any corporation with an unreasonable accumulation. The court found in the original scheme of taxing shareholders as partners the implication that Congress had not intended reference solely to current gains and profits, because pro rata taxation could then have been avoided by preferential distributions, and further noted that in 1928 when the House used the phrase "to remain accumulated" in its bill, neither the House nor the Senate,[38] which reverted to the original words "to accumulate", acknowledged a difference in the meaning of the two phrases. The court determined that the equivalency of these phrases further suggested that Congress was not referring only to current gains and profits. Focusing on the pro rata taxation effect of the early shareholder election provisions, the court next construed these provisions to indicate congressional disapproval of disproportionate distributions as a means of evading the tax and to establish a statutory scheme exempting a corporation only when its entire adjusted net income was included pro rata in the shareholders' gross income. Concluding that Congress never intended to require an accumulation of earnings and profits in the taxable year as a condition precedent to imposition of the tax, the court proceeded to consider the present version of the statute.

Observing first the denial of the dividends-paid deduction for amounts preferentially distributed or reported,[39] the court found further evidence of the congressional policy to encourage pro rata distributions to reduce or avoid the tax. The court stated that it would be inconsistent and contrary to this policy to hold that a disproportionate redemption that did not reduce the measure of the tax could nevertheless allow a corporation to escape the tax entirely. Returning to its discussion of accumulation, the court noted that the present section 532 does not expressly require an accumulation

35. The court quoted a passage describing earnings and profits as "lean[ing] at one time toward the accounting standard and again toward the taxable income standard." 1 J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 9.28 (rev. 1974). *See* note 19 *supra* and accompanying text.

36. Tariff Act of 1913, § II(A)(2), 38 Stat. 166.

37. 50 CONG. REC. 5319 (1913) (remarks of Senators Borah and Williams).

38. *See* reports cited note 16 *supra*.

39. INT. REV. CODE OF 1954, § 562(c).

of current earnings or any particular amount of accumulation, and reasoned that if Congress had meant accumulation in the taxable year, it would have specifically so provided as it had elsewhere.[40] In addition, the court observed that in the case of a corporation formed for the proscribed purpose, there is no need at all to reconsider its accumulation annually. Thus, after citing the Senate Report that declared past accumulations relevant to the propriety of current accumulations for purposes of the accumulated earnings credit,[41] the court held that past accumulations are similarly relevant in determining whether the corporation was availed of for the proscribed purpose. In further support of its position, the court quoted the sections of the *Ostendorf-Morris* opinion[42] describing the unreasonable results to which requiring an increase in earnings in the taxable year might lead. In conclusion, the court stated that, from the determination of the Tax Court that taxpayer was availed of for the proscribed purpose in 1967, and from the role of the redemption of the donated stock in 1968 as a necessary feature of the method of avoiding tax, it appeared that taxpayer was availed of for the proscribed purpose in 1968. Nevertheless, having held only that the decrease in accumulated earnings did not preclude imposition of the accumulated earnings tax, the court remanded for determination of the factual issues of whether an unreasonable accumulation had occurred and whether the corporation had been availed for the proscribed purpose.

IV. COMMENT

The instant court rejected arguments based mainly on the vague wording of the statute and relied on two basic policies—(1) to compel pro rata distributions of unneeded funds that will be taxable to shareholders and (2) to avoid constructions that lead to inconsistent results in similar fact situations. Also, the court seemed to contemplate two theories of liability available to the Commissioner—first, that the corporation was "availed of" by permitting funds not used in the redemption to remain accumulated, and secondly, that the corporation was "availed of" through the redemption itself. The arguments based on the equivalency of the phrases "to accumulate" and "to remain accumulated", the purpose of Congress to reach any corporation with an undue accumulation, and the relevance of past accumulations, plus the remand for determination

40. The court quoted part of the definition of the accumulated earnings credit. INT. REV. CODE OF 1954, § 535(c)(1)(A) (portion quoted note 17 *supra*).

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

42. 26 Am. Red. Tax R.2d 70-5369, 5372-73 (N.D. Ohio 1968).

of whether an unreasonable accumulation actually occurred, relate to the first theory. Other arguments used by the court relate more to the second theory—the repeated idea that preferential distribution of unneeded funds is not a congressionally approved method of abating the penalty tax with respect to those funds, the mention of corporations formed for the proscribed purpose that may be liable without regard to actual accumulation, and especially the concluding statement that the judgment concerning 1967 made liability in 1968 apparent. The second theory is novel because it presents a method by which a corporation may be "availed of" that does not depend on the existence of any accumulation, current or total, in the taxable year, but can be supported in this case on the ground that the plan involved accumulation in a prior year.

The policy considerations and theories of liability of the instant decision have added significance in light of other recent decisions that have increased the attractiveness of charitable bail-out schemes by holding that absent a pregift agreement obligating a corporation to redeem stock donated by a shareholder to a tax-exempt institution, post-gift redemptions do not constitute constructive dividends to the shareholder.[43] Because the ability to redeem suggests unneeded funds[44] and because taxpayers may have difficulty proving the absence of a purpose to avoid tax by this type of transaction, the Commissioner may turn to the accumulated earnings tax as a weapon against the charitable bail-out. The instant decision certainly will assist the Commissioner and may enable him to prevail in two related situations seemingly more favorable to taxpayers—first, when the taxpayer carries out the entire plan of donation, acquisition of funds, and redemption in a single year;[45] and secondly, when the taxpayer reduces both current and total accumulated earnings to zero by the redemption. In the first situation, the taxpayer might distinguish the instant decision on the ground that it depended on either an unreasonable accumulation remaining after the redemption or on accumulation in a prior year as part of the plan. Nevertheless, the policy considerations of the instant decision could still support the assessment. The Commissioner could argue that, as in the instant case, the taxpayer defied congressional will by distributing unneeded funds preferentially to avoid tax, and that to hold the tax inapplicable would be inconsist-

43. Grove v. Commissioner, 490 F.2d 241 (2d Cir. 1973); Daniel D. Palmer, 62 T.C. 75 (1974); *see* 27 VAND. L. REV. 603 (1974).

44. *See* Herwitz, *supra* note 20, at 866.

45. For a further discussion of accumulation during the year of the redemption see Herwitz, *supra* note 20, at 932-37.

ent with the instant case in which the tax applied in two years under facts substantially identical except for the timing of the redemption. In the second situation, the taxpayer could assert the *Farish* rationale and argue that since it had no earnings from which dividends could be paid, it could not have been "availed of" within the meaning of the statute. *Farish* could be distinguished, however, on the ground that the absence of distributable earnings in that case resulted from prior operating losses, not from a transaction that was itself a necessary feature of the tax avoidance plan. The Commissioner could again apply the policies of the instant decision by arguing first that unneeded funds were distributed preferentially and secondly, that to absolve the taxpayer merely because it had no accumulated earnings left over would be inconsistent because a single cent of residual accumulations would allow taxation of taxpayer's entire accumulated taxable income. In either situation, the Commissioner might also adduce the point made in the instant decision that the concept of "earnings and profits" is not rigidly defined in the Code, but is designed to reflect a corporation's capacity to pass along tax consequences to its shareholders through distributions to them. Because the taxpayers described had this capacity prior to the redemptions, the Commissioner could simply argue that they should be estopped from asserting any incapacity that they voluntarily brought upon themselves. Thus, it seems possible for a court to derive from the instant decision the proposition that when, but for a redemption pursuant to a tax avoidance plan, a corporation would have had distributable earnings and profits, the accumulated earnings tax may be applied.

In summary, until courts see fit to uphold constructive dividend treatment of charitable bail-outs, a seemingly more direct approach, the instant decision may make the accumulated earnings tax the Commissioner's primary avenue of attack upon this tax avoidance device.

THOMAS C. HUNDLEY

Errata

Vol. 28, No. 1, p. 159, n.37: delete the words "in another case rejected a good faith defense and;" add the words "(Appeal argued.)" after the word "Corporation."