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RECENT CASES

Civil Procedure—Service of Process—California Long-Arm Statutes Abrogate State's Immunity Doctrine

Seeking recovery of money owed him by defendant European corporations,[1] plaintiff[2] brought suit in a California state court. While attending federal district court in Florida for the sole purpose of giving a deposition in a trademark infringement suit instituted by one of the corporations, defendants' representative[3] was personally served with process[4] in the California action on behalf of himself and the defendant corporations. Defendants moved to quash service of process on the ground that the immunity rule prohibited service of civil process upon a witness in attendance in a court outside of the territorial jurisdiction of his residence. Plaintiff countered by challenging the validity of the immunity rule in light of California's long-arm statutes. On the basis of the immunity doctrine as invoked by defendants, the California trial court granted defendants' motion to quash service of process made upon them in Florida. On appeal

1. Adidas Sportschuhfabriken, 2 other European corporations, and Horst Dassler were named as defendants.

2. Plaintiff, Clifford Severn, was doing business as Clifford Severn Sporting Goods. It was conceded by both parties that defendant corporations had sufficient contacts with California so as to make the exercise of subject matter jurisdiction over them by a California court constitutional.

3. Horst Dassler, a resident of France, was authorized to receive service of process on behalf of defendant corporations under California Code of Civil Procedure § 416.10(b).

4. The pertinent portions of the California Code of Civil Procedure provide as follows:

"A court of this state may exercise jurisdiction on any basis not inconsistent with the Constitution of this state or of the United States." CAL. CODE OF CIV. PROCEDURE § 410.10 (West 1973).

"Except as otherwise provided by statute, a summons shall be served on a person

(a) Within this state, as provided in this chapter.

(b) Outside this state but within the United States, as provided in this chapter or as prescribed by the law of the place where the person is served.

(c) Outside the United States, as provided in this chapter or as directed by the court in which the action is pending, or, if the court before or after service finds that the service is reasonably calculated to give actual notice, as prescribed by the law of the place where the person is served or as directed by the foreign authority in response to a letter rogatory." *Id.* § 413.10.

"A summons may be served by personal delivery of a copy of the summons and of the complaint to the person to be served. Service of a summons in this manner is deemed complete at the time of such delivery." *Id.* § 415.10.

to the California Court of Appeal, *held*, reversed. The enactment of statutes expanding the reach of California's judicial process to every state and to territories outside the United States abrogates the state's common-law immunity doctrine, since such long-arm statutes eliminate the traditional justifications for the immunity rule. *Severn v. Adidas Sportschuhfabriken*, 33 Cal. App. 3d 754, 109 Cal. Rptr. 328 (1973).

Courts of this nation traditionally have accorded witnesses attending court outside the territorial jurisdiction of their residences an immunity or privilege from service of civil process while present at the trial or hearing, and for a reasonable time in traveling to and from court.[5] The historical origins of the immunity doctrine date from early English judicial history when process was effected by the body attachment, or arrest, of the defendant.[6] As adopted and applied in the United States, the rule has been justified by most courts as necessary to prevent the disruption of the court's functioning which would accompany the arrest of an attending witness and to encourage nonresident witnesses to appear in aid of the administration of justice[7] by removing the fear of being subjected to a lawsuit which they might otherwise avoid by remaining outside the court's territorial jurisdiction.[8] The vast majority of states grants the privilege to nonresident witnesses,[9] whether voluntary or subpoenaed,[10] and to nonresident parties.[11] Despite its widespread recognition, the

5. *See, e.g.*, Stewart v. Ramsay, 242 U.S. 128 (1916); Rorick v. Chancey, 130 Fla. 442, 178 So. 112 (1937); Wheeler v. Flintoff, 156 Va. 923, 159 S.E. 112 (1931). *See generally* 62 AM. JUR. 2d *Process* §§ 136-56 (1972); 72 C.J.S. *Process* §§ 80-89 (1951).

6. Powers v. Arkadelphia Lumber Co., 61 Ark. 504, 507, 33 S.W. 842, 843 (1896); Mertens v. McMahon, 334 Mo. 175, 185, 66 S.W.2d 127, 131 (1933); Fisher v. Bouchelle, 134 W. Va. 333, 335-36, 61 S.E. 2d 305, 308 (1950). *See* 12 CATH. U.L. REV. 46, 47 (1963).

7. Lamb v. Schmitt, 285 U.S. 222, 225 (1932); Durst v. Tautges, Wilder & McDonald, 44 F.2d 507, 508-09 (7th Cir. 1930); Moseley v. Ricks, 223 Iowa 1038, 1041, 274 N.W. 23, 24 (1937); Crusco v. Strunk Steel Co., 365 Pa. 326, 328-29, 74 A.2d 142, 143 (1950).

8. Lamb v. Schmitt, 285 U.S. 222, 225 (1932); Marlowe v. Baird, 301 F.2d 169, 170 (6th Cir. 1962). *See generally* 72 C.J.S. *Process* § 80 at 1117-18 (1951).

9. *See, e.g.*, Hollidge v. Crumpler, 72 F.2d 381, (D.C. Cir. 1934); Harris Foundation, Inc. v. District Court, 196 Okla. 222, 163 P.2d 976 (1945); Cotton v. Frazier, 170 Tenn. 301, 95 S.W.2d 45 (1936).

10. In certain jurisdictions the privilege may be invoked only by a witness entering the state voluntarily. *See, e.g.*, Woodward v. Continental Charters, Inc., 203 Misc. 581, 116 N.Y.S.2d 633 (Sup. Ct. 1952).

11. *See, e.g.*, Lamb v. Schmitt, 285 U.S. 222 (1932); Stewart v. Ramsay, 242 U.S. 128 (1916); Murrey v. Murrey, 216 Cal. 707, 16 P.2d 741 (1932), *cert. denied*, 289 U.S. 740 (1933); Vaugbn v. Boyd, 142 Ga. 230, 82 S.E. 576 (1914). *Contra*, Lacharite v. District Court, 74 Idaho 65, 256 P.2d 787 (1953); Christian v. Williams, 111 Mo. 429, 20 S.W. 96 (1892); Ellis v. DeGarmo, 17 R.I. 715, 24 A. 579 (1892). A few jurisdictions have refused to grant nonresident plaintiffs the right to invoke the rule. *See, e.g.*, Wilson Sewing Mach. Co. v. Wilson, 51 Conn.

immunity doctrine has not escaped severe criticism[12] and courts have often limited its applicability.[13] The most common exception to the doctrine was promulgated in *Lamb v. Schmitt*,[14] where the Supreme Court held that the immunity rule would not be applied where the proceeding with regard to which process was issued was integrally related to the principal suit since service of process in the second suit would in no way impede, but would rather facilitate, the administration of justice in the principal suit.[15] Emphasizing that the immunity doctrine was founded not upon the convenience of the individual claiming its protection, but upon that of the court itself,[16] the Court warned "that the privilege should not be enlarged beyond the reason upon which it [was] founded, and that it should be extended or withheld only as judicial necessities require[d]."[17] The "related proceeding" exception recognized in *Lamb* has been followed by most jurisdictions,[18] and the Court's warning language has been echoed frequently by courts seeking to limit application of the doctrine.[19] At least one state, however, has gone beyond merely restricting the rule's applicability and has completely abrogated it. In *Wangler v. Harvey*,[20] the New Jersey Supreme Court examined and discarded the justifications traditionally advanced in support of the doctrine,[21] finding the rule inconsistent with modern concepts of

595 (1884) (dictum); Bishop v. Vose, 27 Conn. 1 (1858); Livengood v. Ball, 63 Okla. 93, 162 P. 768 (1916).

12. *See, e.g.*, Wangler v. Harvey, 41 N.J. 277, 283-85, 196 A.2d 513, 516-18 (1963); Keeffe & Roscia, *Immunity and Sentimentality*, 32 CORNELL L.Q. 471 (1947); 33 HARV. L. REV. 721, 723 (1920).

13. As noted, some jurisdictions have developed "voluntary" versus "compulsory" attendance tests (*see* note 10 *supra*) while others (*see* note 11 *supra*) have refused to extend the rule to nonresident plaintiffs.

14. 285 U.S. 222 (1932).

15. *Id.* at 227-28.

16. *Id.* at 225.

17. *Id.*

18. *See, e.g.*, Walker v. Calada Materials Co., 309 F.2d 74 (10th Cir. 1962) (both cases pertained to judgment allegedly fraudulently obtained by corporation whose officer was served with process in the second action); Velkov v. Superior Court, 40 Cal. 2d 289, 253 P.2d 25 (1953) (defendant appearing in disciplinary proceedings before state bar subject to service of process in declaratory judgment action arising out of alleged irregularities of oil royalties assignments on which disciplinary proceedings were also based); Miller v. Miller, 153 Neb. 890, 46 N.W. 2d 618 (1951) (modification of divorce decree to include child support is merely continuation of divorce proceedings and nonresident husband may not invoke immunity rule).

19. Gaines v. Superior Court, 196 Cal. App. 2d 749, 753, 16 Cal. Rptr. 909, 911 (1961); Crusco v. Strunk Steel Co., 365 Pa. 326, 74 A.2d 142, 143 (1950); Anderson v. Ivarsson, 77 Wash. 2d 391, 393, 462 P.2d 914, 915 (1969).

20. 41 N.J. 277, 196 A.2d 513 (1963).

21. *Id.* at 283-85, 196 A.2d at 516-17.

justice,[22] and substituted in its stead the doctrine of *forum non conveniens.*[23] In addition, it has been suggested recently that expanding concepts of in personam jurisdiction could provide a basis for the total elimination of the immunity doctrine.[24] Historically, a court was powerless to render a binding judgment on a defendant physically absent from the territorial jurisdiction of the court.[25] The immunity rule was therefore necessary to encourage the voluntary entrance of nonresident witnesses and parties who might otherwise remain within their own jurisdictions in order to escape service of process.[26] However, in recent years the concept of in personam jurisdiction has undergone a significant and rapid expansion, and today a state may constitutionally exercise jurisdiction over a nonresident defendant on a wide variety of grounds, many of which do not require the defendant's physical presence within the state.[27] Long-arm statutes authorizing service of process outside a state's borders, and indeed, virtually anywhere in the world, have been upheld as valid, providing the constitutional prerequisites for the court's exercise of jurisdiction exist.[28] Despite this marked expansion of a court's abil-

22. The *Harvey* court noted that the rule irrationally favored nonresidents over residents, was in derogation of the right of a creditor to subject his debtor to suit in any jurisdiction where he might be found, and shifted the burden of traveling to a foreign jurisdiction from the nonresident to the resident party. *Id.*

23. The court observed that *forum non conveniens* is principally concerned with "preventing harassment and vexation to the defendant" and allows a court to utilize its own discretion, rather than an inflexible rule, to prevent imposition upon its trial jurisdiction, when it determines that in the interest of justice and for the convenience of the litigants and witnesses the action should be instituted in another forum. *Id.* at 286, 196 A.2d at 518.

24. Fahy v. Abattoir, 223 Pa. Super. 185, 299 A.2d 323, 325 (1972).

25. Pennoyer v. Neff, 95 U.S. 714, 733 (1877). The necessity of having the defendant physically within the court's jurisdiction in order to serve him has been expressly recognized in several immunity doctrine cases. Hardie v. Bryson, 44 F. Supp. 67, 71 (E.D. Mo. 1942); Fishbein v. Thornton, 247 S.W.2d 404, 408 (Tex. Civ. App. 1952).

26. *See* materials cited in note 8 *supra.*

27. *E.g.,* McGee v. International Life Ins. Co., 355 U.S. 220 (1957) (insurance company which had done no business on a continuing basis in California other than the single policy being sued on was subject to the jurisdiction of the California court because of the substantial connection of the insurance contract with the state); International Shoe Co. v. Washington, 326 U.S. 310 (1945) (systematic activities of defendant corporation within the state sufficient to constitute "doing business" so as to authorize a finding of presence for purposes of obtaining jurisdiction). For an excellent treatment of the development of constitutional bases for exercising jurisdiction over non-residents since *Pennoyer,* see *Developments in the Law—State-Court Jurisdiction,* 73 HARV. L. REV. 909, 919-48 (1960). *See also* F. JAMES, CIVIL PROCEDURE §§ 12.2-.11 (1965); RESTATEMENT (SECOND) OF CONFLICT OF LAWS §§ 27-52 (1971).

28. In addition to the constitutional "minimum contacts" requirement, *see* note 26 *supra,* the Supreme Court has held that due process requires that the defendant receive "notice reasonably calculated, under all the circumstances, to apprise [him] of the pendency of the action and afford [him] an opportunity to present [his] objections." Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950).

ity to obtain and exercise jurisdiction over nonresident defendants, the immunity doctrine has for the most part remained static, and virtually no courts have re-examined the issue of its efficacy in light of modern bases of in personam jurisdiction.[29]

The instant court initially examined the historical origins of the immunity doctrine, citing as its two main purposes the prevention of disruption of judicial proceedings and the encouragement of nonresident witnesses to appear in aid of the administration of justice. The court then noted that the development of the doctrine had been far from uniform and that criticism of the rule had been widespread, with the result that many jurisdictions had placed limitations on its operation, and at least one state had ceased to apply it.[30] Relying on *Lamb v. Schmitt* and subsequent California decisions[31] applying the *Lamb* limitations, the majority delineated three principles restricting the immunity rule: first, that the rule extended no rights to the nonresident witness but rather existed only for the convenience and benefit of the court before which the nonresident was appearing; secondly, that the rule applied only where the nonresident witness voluntarily entered the territorial jurisdiction of the court; and thirdly, that the rule should not be enlarged beyond the reason upon which it was founded and should be extended or withheld only as judicial necessities required. After observing that California had a strong public policy supporting the right of a creditor to subject his debtor to suit wherever he could be found and served, the court noted that the state's recently enacted Code of Civil Procedure[32] implemented this policy by authorizing service of process beyond the state's borders and even outside the United States so long as made in a manner permitted by California law. The majority then focused on the third principle of the immunity rule as enunciated in *Lamb* and noted that as states had gradually extended the reach of a court's judicial process from the county boundaries to the state's borders and nonresident witnesses were no longer immune from a county's process merely by remaining at home, various courts began to deny application of the rule as between counties.[33]

29. *But see* Silfin v. Rose, 17 Misc. 2d 243, 185 N.Y.S.2d 90 (Sup. Ct. 1959) (immunity doctrine inapplicable where under New York nonresident motorist statute nonresident defendant appearing as witness in principal case could have been served with process without coming into state).

30. *See* notes 20-22 *supra* and accompanying text.

31. Velkov v. Superior Court, 40 Cal. 2d 289, 253 P.2d 25 (1953); Gaines v. Superior Court, 196 Cal. App. 2d 749, 16 Cal. Rptr. 909 (1961); St. John v. Superior Court, 178 Cal. App. 2d 794, 3 Cal. Rptr. 535 (1960).

32. *See* note 4 *supra.*

33. *Citing* Christian v. Williams, 111 Mo. 429, 20 S.W. 96 (1892).

Analogizing to this limitation and the reasoning behind it, the court observed that California's recently enacted long-arm statutes permit service of process on a defendant virtually anywhere in the world, provided the requisite subject matter jurisdiction exists. By virtue of these statutes, the court reasoned, nonresident defendants were no longer secure in the state or country of their residence from the reach of California's process and thus the immunity rule could offer them no encouragement to enter the state in aid of its judicial administration. Since defendants in the instant case could have been served at their European places of residence or business, the court concluded that the immunity rule had no legitimate application to them. Under *Lamb*, the majority observed, the doctrine should not be applied where the reason for its application was no longer valid or where judicial necessity did not require it;[34] therefore, the court held the immunity doctrine was no longer the law of California. Finally, the majority stated that, since both federal courts and Florida state courts followed the *Lamb* limitations on the immunity rule, neither could have any legitimate interest in applying the rule when the reason for its application had vanished. Furthermore, the court concluded, even if federal and Florida state law differ from that adopted by California, interstate comity allows the public policy and law of California to determine the validity of the service of process on defendants. The dissent, however, observed that, although process is usually that of the same forum which is seeking to protect the pending litigation, the instant case involved two forums. Therefore, the dissent reasoned, the administration of justice was primarily a concern of the Florida federal district court and the California courts should not arbitrarily apply their will in exercising jurisdiction over a nonresident defendant served outside the state, if such action would be deemed to interfere with the administration of justice at the place where the service was effected. Concluding that federal or Florida law should be applied, the dissent examined the Supreme Court cases of *Stewart v. Ramsay*[35] and *Page v. Macdonald*[36] and pertinent Florida cases[37] and determined

34. Lamb v. Scbmitt, 285 U.S. 222, 225 (1932).

35. 242 U.S. 128 (1916) (recognition and acceptance of the immunity doctrine for nonresident suitors as well as for witnesses).

36. 261 U.S. 446 (1923) (a federal court is not foreign and antagonistic to a court of the state in which it sits within the principle of *Stewart v. Ramsay*, and therefore a nonresident defendant served with process from a federal court while attending an action in state court in the same state may invoke the immunity rule).

37. *E.g.*, State v. Adams, 148 Fla. 426, 4 So. 2d 457 (1941); Rorick v. Chancey, 130 Fla. 442, 178 So. 112 (1937), *rev'd on other grounds*, 142 Fla. 290, 195 So. 418 (1938).

that if plaintiff's suit had been commenced in either the Florida federal district court or a Florida state court, service of process on defendants would have been quashed under federal and Florida law. Although recognizing recent expansions of the concept of jurisdiction and admitting that under the California long-arm statute the court in the instant case had acquired jurisdiction to proceed, the dissent nevertheless argued that the court's exercise of that jurisdiction placed an unreasonable restraint on the right of the state and federal courts of Florida to have applied what they deemed to be a reasonable rule to further judicial proceedings in their courts.[38]

The significance of the instant decision lies more in its precedential impact than in its practical effect. The court's holding subjects foreign corporations having the requisite minimum contacts with California to service of process in any court[39] in which they may be present in connection with another action, regardless of whether the two actions are related. Realistically speaking such a result is not likely to prove either highly advantageous to plaintiffs or disadvantageous to the nonresident corporations they are seeking to serve with summons, since California's Code of Civil Procedure permits service of process on such defendants in numerous other ways.[40] The majority's reasoning in reaching its conclusions regarding the destruction of the basis for the immunity doctrine by the enactment of long-arm statutes is logically correct. If a nonresident can legitimately be served outside of California, he is not subjected to a risk of additional litigation by entering the state, and the immunity doctrine can offer him no encouragement to come into California in aid of litigation pending there. The dissent, however, correctly characterized the Florida and federal law position on the immunity doctrine,[41] an issue with regard to which the majority opinion was somewhat evasive. Had the majority analyzed and weighed the competing interests of the California court and the Florida federal district

38. The dissent pointed out that the California court could still obtain jurisdiction over defendants by serving them at their European places of business or residence pursuant to § 413.10(c) of the Code of Civil Procedure, or by attaching any property defendants migbt have within the state. 33 Cal. App. 3d at 777, 109 Cal. Rptr. at 343-44.

39. Although the instant case deals with a dual-forum situation, the scope of the holding is obviously intended to encompass the case where tbe nonresident corporation is suing or being sued in a California forum and process issues in the second California action.

40. *See* CAL. CODE OF CIV. PROCEDURE §§ 415.20-.50 (West 1973) (authorizing service by leaving a copy of the summons and complaint at defendant's office, residence, or place of business; by mail; or by publication).

41. Page v. Macdonald, 261 U.S. 446 (1922); McDonnell v. American Leduc Petroleums, Ltd., 456 F.2d 1170 (2d Cir. 1972); Rorick v. Chancey, 130 Fla. 442, 178 So. 112 (1937), *rev'd on other grounds*, 142 Fla. 290, 195 So. 418 (1938).

court involved, it might easily have found the degree of disruption actually caused in the federal action by the serving of process on defendant[42] during his deposition to be greatly outweighed by California's public policy of allowing creditors to serve their debtors wherever they might be found. The court, however, failed to engage in any kind of balancing process, and the force of its argument was consequently lessened somewhat. Furthermore, the dissent's contention that the instant decision places an unreasonable restraint on the right of the state and federal courts of Florida to have applied what they deem to be a reasonable rule to further proceedings in their courts[43] raises the possibility of a full faith and credit clause[44] issue. The question becomes whether that clause requires California to give full faith and credit to the immunity rule as interpreted and applied by the judicial decisions of Florida. The current test for a state's right to apply its own law in a conflicts situation seems to be one of "minimum contacts,"[45] which California unquestionably has in the instant case. But it is at least arguable that the instant conflict should not be governed by that test, for the simple reason that application of the minimum contacts test here may not yield the most appropriate results. The California court is clearly interfering with the right of another jurisdiction to regulate the internal functioning of its own courts. The precedential impact of such a decision could be siguificant, and although there seems to be no previous authority in the area, it is conceivable that a strong constitutional argument could be made against California's right to interfere in what would seem to be so unquestionably an internal concern of the Florida federal district court. The immunity doctrine may have outlived its usefulness in light of modern day long-arm statutes, and the California court here has acted logically in abrogating the rule's operation within the state, but the constitutionality of its decision with regard to the full faith and credit clause remains open to question and should be examined more closely in light of the right of each state to regulate internally the procedures of its own courts.

42. Some jurisdictions denying immunity from service of process have done so at least partially on the basis that the actual serving of the summons would not create such a distraction that the due administration of justice would be impaired. *E.g.*, Lacharite v. District Court, 74 Idaho 65, 68, 256 P.2d 787, 789 (1953); *cf.* Mertens v. McMahon, 334 Mo. 175, 185, 66 S.W.2d 127, 131 (1933).

43. 33 Cal. App. 3d at 777, 109 Cal. Rptr. at 343.

44. "Full Faith and Credit shall be given in each State to the public Acts, Records, and judicial Proceedings of every other State. And the Congress may by general Laws prescribe the Manner in which such Acts, Records and Proceedings shall be proved, and the Effect thereof." U.S. CONST. art. IV, § 1.

45. Watson v. Employers Liab. Assurance Corp., 348 U.S. 66 (1954); *see* R. LEFLAR, AMERICAN CONFLICTS LAW § 73, at 140-41 (1959). *See generally id.* §§ 56-64.

Constitutional Law—Right to Counsel—Due Process Entitles Convicted Indigents to Appointed Counsel in Petitioning for Discretionary Appeals

Appellant, an indigent whose separate felony convictions[1] had been affirmed[2] on appeals as of right,[3] sought writs of habeas corpus in two federal district courts[4] alleging that state court refusals to appoint attorneys to assist him in the preparation of petitions for writs of certiorari in his efforts to obtain further, discretionary appellate review[5] denied him a constitutionally protected right to counsel. He contended that since the constitution required appointment of counsel on a guaranteed appeal, he should likewise be entitled to representation in seeking an analogous discretionary review by the state and federal supreme courts. Finding his argument without merit, the district courts refused to issue the writs. On appeal to the United States Court of Appeals for the Fourth Circuit, *held*, reversed and remanded.[6] Due process of law requires that an indigent defendant seeking permissive appeal be given the same assistance of court-appointed counsel to which he is entitled in exercising an initial appeal as of right. *Moffitt v. Ross*, 483 F.2d 650 (4th Cir.

1. Appellant was twice convicted of forging and uttering forged instruments, first in Mecklenburg County, N.C. and thereafter in Guilford County, N.C.

2. Affirmance of the Guilford County conviction by the North Carolina Court of Appeals is reported as State v. Moffitt, 11 N.C. App. 337, 181 S.E.2d 184 (1971).

3. Appellate review in each case was by the North Carolina Court of Appeals, to which an appeal as of right is provided in all criminal cases except those resulting in sentences of death or life imprisonment, in which guaranteed appeal is provided directly to the North Carolina Supreme Court. N.C. GEN. STAT. § 7A-27(a), (b) (1969).

4. Petitions for writs of haheas corpus in the Mecklenburg and Guilford County cases were filed in the United States District Courts for the Western and Middle Districts of North Carolina, respectively.

5. Following affirmance of the Mecklenburg conviction by the North Carolina Court of Appeals, the trial court refused to appoint counsel to prepare and file a petition for a writ of certiorari in the North Carolina Supreme Court. The trial court in the Guilford County case, however, appointed the Public Defender to apply for a writ of certiorari in the state supreme court. When the petition was dismissed for lack of a substantial constitutional question, State v. Moffitt, 279 N.C. 396, 183 S.E.2d 247 (1971), appellant's requests to the trial court and Court of Appeals for appointment of counsel to prepare and file a writ of certiorari in the United States Supreme Court was denied.

6. The United States District Court for the Western District of North Carolina was instructed to issue the writ of habeas corpus in the Mecklenburg County case unless the State provided counsel within a reasonable time. The United States District Court for the Middle District of North Carolina was instructed to grant the writ of habeas corpus in the Guilford County case if appellant in his petition to the North Carolina Supreme Court asserted a substantial federal question reviewable by the United States Supreme Court on a writ of certiorari.

1973), *cert. granted*, ___ U.S. ___, 94 S. Ct. 864 (1974).

The convicted indigent's entitlement to appointed counsel on an *initial*, guaranteed appeal owes its origin to *Douglas v. California*.[7] The Supreme Court there held that granting appellate review of all cases of conviction without appointing counsel for all indigents[8] discriminates against some defendants on the basis of their poverty thus depriving them of equal protection of the laws.[9] Relying on the *Griffin v. Illinois*[10] decision that all indigent defendants must be furnished free transcripts on appeal, the *Douglas* Court concluded that there can be no equal justice where the quality of the appeal depends on the defendant's financial status.[11] The Court expressly reserved, however, the question whether an indigent seeking further discretionary or mandatory review after affirmance of his conviction on an initial appeal as of right would likewise be entitled to counsel. Subsequently, two federal circuits answered the question negatively.[12] In *Peters v. Cox*,[13] the Court of Appeals for the Tenth Circuit, in a *per curiam* denial of a writ of habeas corpus, noted simply that *Douglas* had not extended the right to counsel to discretionary appeals and that the appellant consequently had no right to a court appointed attorney. The issue was considered more fully by the Seventh Circuit in *United States ex rel. Pennington v. Pate*.[14] The court concluded that appointment of counsel was not constitutionally mandated not only because of the narrowness of the *Douglas* holding but also because of the Supreme Court's practice of not granting counsel for the purpose of preparing certiorari petitions[15] and the practical difficulties of implementing an expansion of state-provided counsel. Some state courts, however, have been

7. 372 U.S. 353 (1963).

8. California required appointment of counsel only if the appellate court determined in an independent investigation of the record that it would be advantageous to the defendant or helpful to the court to supply counsel. *Id.* at 355.

9. U.S. CONST. amend. XIV, § 1 provides ". . . nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws."

10. 351 U.S. 12 (1956).

11. *See id.* at 19.

12. In addition see United States *ex rel.* Coleman v. Denno, 313 F.2d 457 (2d Cir.) (decided 2 months before *Douglas*), *cert. denied*, 373 U.S. 919 (1963) (2 months after *Douglas*) (furnishing of counsel at all stages of the state appellate system except in the preparation of applications for writs of certiorari to the Supreme Court satisfied the *Griffin* principle).

13. 341 F.2d 575 (10th Cir.), *cert. denied*, 382 U.S. 863 (1965).

14. 409 F.2d 757 (7th Cir. 1969), *cert. denied*, 396 U.S. 1042 (1970).

15. The current policy of the federal courts, expressed in Doherty v. United States, 404 U.S. 28 (1971), is to require court-appointed counsel to prepare certiorari petitions for indi-

more amenable to such an extension. In *Cabaniss v. Cunningham*,[16] the Virginia Supreme Court held that indigents were entitled to appointed counsel in the preparation of applications for writs of error by which that court grants discretionary review of trial court convictions.[17] In some jurisdictions right to counsel has also been extended to collateral attacks on convictions[18] on the broad premise that whenever a state affords a direct or collateral remedy a refusal to supply counsel invidiously discriminates between rich and poor.[19]

In the instant case, the court noted initially that, although access is normally a matter of grace, the highest court of a state remains the ultimate guardian of the rights of the state's citizens and may provide, on constitutional questions, the most meaningful post-conviction review. Citing *Douglas*, the court reasoned that if denial of counsel on an intermediate appeal as of right so prejudices a defendant that the requirements of due process or equal protection are violated, refusal to appoint counsel to assist in seeking relief in the highest state court constitutes a comparable deprivation. That the defendant has already received counsel for one appeal does not mitigate the harm, the court argued, for his need for legal assistance is as genuine in seeking discretionary review as it was in exercising

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gents. The court based its decision on statutory rather than constitutional grounds, *viz.* the Criminal Justice Act of 1964, 18 U.S.C. §§ 3006A(c), 3006A(d), 3006A(g), and FED. R. CIV. P. 44(a). Rule 44(a) provides:

> Every defendant who is unable to obtain counsel shall be entitled to have counsel assigned to represent him at every stage of the proceedings from his initial appearance before the commissioner or the court *through appeal*, unless he waives such appointment.

(Emphasis added.) Section 3006A(c) of the Criminal Justice Act provides:

> A person for whom counsel is appointed shall be represented *at every stage of the proceedings* from his initial appearance before the United States magistrate or the court *through appeal*, including ancillary matters.

(Empbasis added.)

16. 206 Va. 330, 143 S.E.2d 911 (1965).

17. *Accord*, Hutchins v. State, No. 6-Sullivan (Tenn. Sup. Ct., filed Jan. 21, 1974) (state statutory grounds).

18. In Alaska, appointment of counsel is provided in a post-conviction proceeding if the petition presents an issue requiring a hearing. Nichols v. State, 425 P.2d 247 (Alas. 1967). The rule is similar in Idaho. Austin v. State, 91 Idaho 404, 422 P.2d 71 (1966); *but cf.* Wilbanks v. State, 91 Idaho 608, 428 P.2d 527 (1967). In Maryland, appointment is by court rule. Taylor v. Director, Patuxent Institution, 1 Md. App. 23, 226 A.2d 358 (1967). In Missouri, appointed counsel is discretionary but preferred in all cases. State v. Garner, 412 S.W.2d 155 (Mo. 1967). In Kansas, it is required only if substantial questions of law or triable issues of fact are presented. Carter v. State, 199 Kan. 290, 428 P.2d 758 (1967). *See also* Harper v. State, 201 So. 2d 65 (Fla. 1967). It is reversible error in Pennsylvania to fail to make an appointment. Commonwealth v. Hoffman, 426 Pa. 226, 232 A.2d 623 (1967). *See also* Commonwealth v. Mitchell, 427 Pa. 395, 235 A.2d 148 (1967) (Pennsylvania statute makes appointment mandatory).

19. *See* People *ex rel.* Rogers v. Stanley, 17 N.Y.2d 256, 217 N.E.2d 636, 270 N.Y.S.2d

his guaranteed appeal.[20] Further, it is unfair, the court pointed out, to withhold appointed counsel from the indigent while he is petitioning for further review when more affluent defendants can take advantage of the second tier of appeals by retaining an attorney. Recognizing the contrary results of the *Pennington* and *Peters* decisions, the court noted merely that due process is an evolving concept and that the growth of the Bar subsequent to these decisions now makes possible the further implementation of basic ideas of fairness that a previous inadequacy of legal resources[21] might have rendered impractical. The additional burden imposed on the Bar by extending the right to counsel will be slight, the court concluded, since preparation of a petition for further review can easily be prepared by the attorney who handled the initial appeal and who is already familiar with the details of the case. Moreover in present practice, once certiorari is granted courts ordinarily appoint an attorney for an unrepresented indigent. Because no logical basis exists for distinguishing guaranteed and discretionary review, due process[22] requires that a convicted indigent be supplied counsel for the purpose of preparing a petition requesting permissive appellate review in the state and federal supreme courts.

By creating a conflict among the Circuit Courts of Appeal, this decision provides the Supreme Court with the opportunity to determine whether a significant gap in the right to counsel during the guilt-determining process is to be filled.[23] There is little doubt that a serious differential exists in the quality of justice available to the rich and the poor by virtue of the inability of the poor to obtain

573 (1966) (indigent mental patient has a federal constitutional right to counsel in a habeas corpus proceeding); People v. Monahan, 17 N.Y.2d 310, 217 N.E. 2d 664, 270 N.Y.S.2d 613 (1966) (indigent has federal constitutonal right to counsel in *coram nobis* proceedings). Based on these decisions, which were grounded in the equality principle expressed in *Griffin* and *Douglas*, the New York Court of Appeals has held that petitioners are entitled to assigned counsel at habeas corpus hearings. People *ex rel.* Jenks v. McMann, 27 App. Div. 2d 580, 275 N.Y.S.2d 399 (1966); People *ex rel.* Rodriquez v. LaValee, 26 App. Div. 2d 8, 270 N.Y.S.2d 340 (1966); *cf.* People v. Sbipman, 62 Cal. 2d 226, 397 P.2d 993, 42 Cal. Rptr. 1 (1965).

20. "Certiorari practice constitutes a highly specialized aspect of appellate work. The factors which [a court] deems important in connection with deciding whether to grant certiorari are certainly not within tbe normal knowledge and experience of an indigent appellant . . . ." Boskey, *The Right to Counsel in Appellate Proceedings*, 45 MINN. L. REV. 783, 797 (1961) (footnote omitted).

21. In reacbing its decision in *Pennington*, the Seventh Circuit relied in part on the practical difficulties which it believed inherent in extending the right to counsel. 409 F.2d at 760.

22. The court did not indicate why it chose to ground its decision in terms of due process rather tban equal protection, as the Supreme Court did in *Douglas*.

23. *See* Boskey, *supra* note 19, at 797.

professional legal assistance in the preparation of petitions for writs of certiorari for presentation to state and federal supreme courts. In *Douglas*, the Supreme Court assumed that certain substantial benefits flow automatically from the presence of counsel: examination of the record, research of the law, and marshalling of arguments.[24] These benefits are particularly critical in the case of certiorari applications since their successful preparation requires a high degree of skill in identifying and emphasizing factors which motivate courts to take the statistically unusual step of granting review.[25] The seriousness of the unrepresented appellant's disadvantage is heightened by the fact that in preparing his *pro se* petition, the indigent, who is not only untrained in spotting legal issues but is also frequently inarticulate in expressing what he does perceive, is usually exhausting his last chance to have a court look at the fundamental determination of guilty and to *directly* attack the propriety of the pretrial and trial proceedings. In *Douglas*, the Court concluded that the kind of appeal accorded a defendant cannot hinge on whether he can pay for the assistance of counsel. By the same rationale, the meaningfulness of a defendant's opportunity to persuade a court to exercise its discretionary power of review should not depend on his wealth since the question of the quality of access to the courts, with which the *Douglas* opinion dealt, comes into existence even prior to the time when a discretionary appeal is granted. The petitioning process places before the court the issue whether the case should be the subject of review and thus is itself access, the quality of which depends upon assistance of counsel. That the mere filing of a certiorari application gives the petitioner access to the substantive decision-making process of the court is further emphasized by the fact that the United States Supreme Court occasionally disposes of the *merits* of the case, as well as the important but procedural question of whether to grant review, by summary affirmance or reversal at the same time certiorari is granted. In the sense, however, that the issue is usually whether the defendant is to have an appeal at all, it is more important that he be represented in the discretionary situation than in that of the *Douglas* case, in which the defendant was at least certain that he would have an appeal. Furthermore, an anomalous situation is created by supreme courts' practice of automatically granting counsel to indigents once certiorari is granted, while denying them counsel for an integral, and per-

24. 372 U.S. at 357-58.

25. *See* Boskey, *supra* note 19, at 797.

haps the most difficult, part of the appellate process—the petitioning stage. Ultimately, the issue resolves itself into the question whether the Court will recognize and implement the broad constitutional policy of equalizing to the extent feasible the quality of justice available to the rich and the poor that *Griffin* and *Douglas* seemed to announce.[26] The broad implications of such a policy, beyond petitions for discretionary appeals, have been suggested elsewhere.[27] Attempts to provide a rationale for limiting the policy to transcripts, and to counsel initial appeals as of right—that is, to the facts of *Griffin* and *Douglas*—seem unsatisfactory.[28] No persuasive reasons seem to exist for applying different standards to discretionary appeals than to guaranteed appeals when the final goal is a fair criminal procedure. Whether the fact that the indigent has already been represented by counsel in one appellate review is sufficient for a finding that he has not been treated unfairly in any fundamental

26. Some commentators and courts have questioned whether *Griffin* and *Douglas* stand for such a general principle. The Seventh Circuit in *Pennington*, for example, read *Griffin* and subsequent transcript cases as requiring only that indigents be allowed *access* to the courts and not that the quality of the available review be equal to that of the more affluent. 409 F.2d at 759. The "presence of counsel is not a *sine qua non* to access to the courts, as was the availability of the transcript in the *Griffin* case." 55 MICH. L. REV. 413, 420 (1957). The Supreme Court in *Douglas*, however, indicated that *Griffin* had a broader import. "In either case"—whether the denial is of a free transcript or of appointed counsel on an initial appeal—"the evil is the same: discrimination against the indigent." 372 U.S. at 355. The critical factor in *Griffin*, and the tie which binds it with *Douglas*, is thus the distinctly disadvantageous treatment given the indigent, and the "access" interpretation of *Griffin* must, after *Douglas*, "be substantially revised, if not abandoned." Kamisar & Choper, *infra* note 26, at 13.

The *Douglas* equality principle is limited to *initial* appeals, it is argued, because the "first appeal, the only appeal of right, appears sufficiently more important than any subsequent phase of review—the need for counsel at this step of the appellate process seems sufficiently more 'acute' than at other stages—that the line may rationally be drawn here." *Id.* at 11-12. But once the premise is accepted that the procedure overturned in *Douglas* violates either equal protection or due process, it is difficult logically to distinguish the initial appeal. Instead, the logic adopted by the 6-member *Douglas* majority leads ineluctably toward granting counsel at subsequent stages. *See* remarks of Justice Harlan, *infra* note 28.

27. *See* Kamisar & Choper, *The Right to Counsel in Minnesota: Some Field Findings and Legal-Policy Observations*, 48 MINN. L. REV. 1, 4-9 (1963); Note, *Right to Aid in Addition to Counsel for Indigent Criminal Defendants*, 47 MINN. L. REV. 1054 (1963); Note, *Right to Counsel in Federal Collateral Attack Proceedings: Section 2255*, U. CHI. L. REV. 583 (1963). With respect to whether the *Griffin-Douglas* equality principle should be extended to provide counsel for collateral attacks, it has been suggested that one basis for distinguishing between them and discretionary appeals is that the latter is part of the critical guilt-determining process, while the former is not. Providing counsel for discretionary appeals would thus not necessitate automatic appointment for habeas corpus or *coram nobis* proceedings. *But see id.*

28. *See* Kamisar & Choper, *supra* note 26, at 9-13.

sense, and thus has not been deprived of due process of law, depends on the difficulty with which one's sense of fairness is offended.[29] In deciding what degree of fairness is to be accorded at different procedural steps in the appellate process, it should be kept in mind, though, that the extent of the judicial commitment to "equal justice under law" and, in a very real sense, the meaningfulness of the guarantee itself, is being determined.[30] But whatever the disposition of the *due process* claim upon which the Fourth Circuit grounded its decision, merely pointing to the right to counsel in the prior review is no answer to an equal protection objection in the instant case if one accepts the *Douglas* premise that once the government provides access to the courts it must not place the poor at a disadvantage in utilizing the remedy. While it is true that practical considerations place limits on the extent to which the logic of general principles may be pursued, it is clear in this instance, as the Fourth Circuit noted, that the practical difficulties in instituting the practices mandated by the logic are not great. In the usual situation, the only additional strain imposed on our legal resources will be the preparation of one additional document by an attorney already familiar with the case. This imposition is far less than that caused by the extension of counsel to all misdemeanor trials from

29. Justice Harlan, in his dissent to *Douglas*, contended that the holding of the majority, which was based on equal protection, was more properly understood in terms of due process. Seeing nothing fundamentally unfair about the California appellate court granting counsel only to those indigents it thought had arguahle appeals, he contended that due process had not been violated. He stressed, however, that if denial of automatic right to counsel deprived indigents of due process on initial appeals as of right (which he argued the majority must have concluded), denial of counsel at subsequent stages would he an equal deprivation:

> What the Court finds constitutionally offensive in California's procedure bears a striking resemhlance to the rules of this Court and many state courts of last resort on petitions for certiorari or for leave to appeal filed by indigent defendants *pro se* . . . . Since our review is generally discretionary, and since we are often not even given the benefit of a record in the proceedings below, the disadvantages to the indigent petitioner might be regarded as more suhstantial than in California . . . . The Court distinguishes our review from the present case on the grounds that the California rule relates to 'the first appeal, granted as a matter of right' . . . . But I fail to see the significance of this difference. Surely, it cannot be contended that the requirements of fair procedure are exhausted once an indigent has been given one appellate review . . . . Nor can it well he suggested that having appointed counsel is more necessary to the fair administration of justice in an initial appeal taken as a matter of right, which the reviewing court on tbe full record has already determined to he frivolous, than in a petition asking a higher appellate court to exercise its discretion to consider what may be a substantial constitutonal claim.

372 U.S. at 365-66. Thus a refusal to recognize the claim of the prisoner in the instant case would seem to require, in effect, a rejection of the basic premises of *Douglas*.

30. *See* Boskey, *supra* note 19, at 784-85.

which imprisonment may result—an extension which the Supreme Court ordered with little hesitation.[31] To extent the right to counsel to certiorari applications merely completes[32] the process of recognizing that representation by counsel is a necessary part of any truly fair criminal procedure.

Constitutional Law—Right of Privacy—Personality Test Used by School to Identify Potential Drug Abusers Without Informed Consent of Parents Violates Student's and Parents' Right of Privacy

Plaintiffs, an eighth grade student[1] and his mother, brought suit against defendant school board[2] to enjoin the implementation of a drug-abuse-prevention program (CPI) in which students were psychologically tested and then required to participate further in the program if test results showed them to be potential drug abusers.[3] Plaintiffs alleged that the testing program, despite any posi-

31. *See* Argersinger v. Hamlin, 407 U.S. 25, 37 (1972) (absent a knowing and intelligent waiver, no person may be imprisoned for any offense unless he was represented by counsel).

32. *But see* Note, *Right to Counsel in Federal Collateral Attack Proceedings: Section 2255*, 30 U. CHI. L. REV. 583, 596 (1963) (urging extension of right to counsel to collateral proceedings).

1. Plaintiff was an eighth grade student at Stewart Junior High School in Norristown, Montgomery County, Pa.

2. In addition to the Norristown Area School Board, the Montgomery County Commissioners, the Superintendent of Schools, and the principal of the junior high school also were joined as defendants.

3. The program, entitled Critical Period of Intervention (CPI), was designed as a drug prevention rather than a drug rehabilitation approach. It was to aid the local school district in identifying potential abusers, preparing the necessary interventions, identifying resources to train, aiding the district personnel in remediating the problems, and evaluating the results. The identification of a potential drug abuser was to be accomplished by requiring students and their teachers to complete test questionnaires that included inquiry into family relationships and religion, and additionally asked for identification of other students who make unusual remarks, get into fights, make unusual or inappropriate responses, or have to be coaxed or forced to work with other pupils, though no instruction is given as to the meaning of "unusual" or "inappropriate." The second step of the program was to be "intervention" or "remediation"—the stated purpose of this phase being "to change the cognitive and affective domains of potential drug abusers and other forms of deviant behavior." This intervention was to take several forms, one of which, Guided Group Interaction, specifically was described as "involuntary" and in which "[d]eviancy is painstakingly defined and discouraged by the group itself." Members are compelled to explain why they have been assigned to

tive aspects it might have, invaded their rights of privacy[4] by asking personal questions relating to the family relationship[5] and by not specifically assuring confidentiality of test results.[6] Plaintiffs further argued that students are entitled to exercise their constitutional rights and that the program was involuntary in the sense that the parental consent letter did not provide information sufficient to enable the making of an informed waiver of the constitutionally protected right of privacy.[7] Defendants maintained, however, that the legislature had vested the school board with the discretionary power to act, to include the testing of its students, and that the program was justified by the overwhelming public interest in drug prevention. Rejecting defendants' contentions, the United States District Court for the Eastern District of Pennsylvania, *held*, judgment for plaintiffs.[8] A school's use of a personality test that asks intimate questions about the family relationship to identify potential drug abusers without first obtaining the consent of properly informed parents constitutes a violation of the student's and parents' constitutionally protected right of privacy. *Merriken v. Cressman*, 364 F. Supp. 913 (E.D. Pa. 1973).

Although freedom from invasions of privacy by the state can be traced to Lord Camden's famous opinion over two centuries ago,[9] the right did not receive its constitutionally protected status until

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the program. The group may impose sanctions on members, including work detail, withdrawal of past privilege, recommendation to a special unit for intensive training, or the assignment of more onerous tasks.

4. *See* note 11 *infra*. Plaintiffs also claimed that the CPI program would interfere with and impede their rights of freedom of religion, freedom of speech, freedom of assembly, and privilege against self-incrimination.

5. The questionnaires asked questions dealing with the family religion, the family composition, including the reason for the absence of one or both parents, and whether one or both parents "hugged and kissed me good night when I was small," "tell me how much they love me," "enjoyed talking about current events with me," and "make me feel unloved."

6. Although the CPI program constantly referred to confidentiality, no specifics were given in the program itself as to how confidentiality was to be maintained. In fact, the program, by its own terms, contemplated the development of a "massive data bank" and also dissemination of data relating to specific students to various school personnel, including superintendents, principals, guidance counselors, athletic coaches, social workers, PTA officers, and school board members.

7. When suit was first instituted, defendants did not intend to obtain the affirmative consent of parents to the participation of their children in the CPI program. It was only after suit was started that defendants offered to change the format so that affirmative parental consent to participation in the CPI program would be required.

8. The court held that the action was brought to redress deprivation, under color of state law, on the rights, privileges, and immunities secured by article I, section 9, clause 3 and the first, fourth, fifth, ninth, and fourteenth amendments of the United States Constitution and that it therefore had jurisdiction pursuant to 28 U.S.C. §§ 1331, 1343 (1970).

9. Entick v. Carrington, 95 Eng. Rep. 807 (K.B. 1765).

the United States Supreme Court held, in its 1965 decision in *Griswold v. Connecticut*,[10] that the marital relationship is surrounded by a zone of privacy that is constitutionally protected from the unnecessary intrusion of state action.[11] More recently, in *Roe v. Wade*,[12] the right of privacy was held to be guaranteed by the fourteenth amendment alone. While *Roe* extends the right of privacy to include the right of a woman to decide whether to have an abortion,[13] neither *Roe* nor *Griswold* offers much guidance in distinguishing what is privacy from what is not,[14] nor do they delineate exactly the areas to which the right extends.[15] Indeed, while the courts consistently have upheld the right of privacy with regard to home and family,[16] they have reached conflicting conclusions on the extension

10. 381 U.S. 479 (1965). This is not to say that a right of privacy was not alluded to in a number of earlier decisions. *See, e.g.*, Mapp v. Ohio, 367 U.S. 643, 656 (1961) (fourth amendment held applicable to state action under the fourteenth amendment; the exclusion doctrine is an essential part of the right to privacy); Olmstead v. United States, 277 U.S. 438, 478 (1928) (Brandeis, J., dissenting) ("[The makers of our Constitution] conferred, as against the Government, the right to be let alone—the most comprehensive of rights and the right most valued by civilized man."); Boyd v. United States, 116 U.S. 616, 630 (1885) (protection of fourth and fifth amendments: "The principles laid down in this opinion affect the very essence of constitutional liberty and security. They reach farther than the concrete form of the case then before the court, with its adventitious circumstances; they apply to all invasions on the part of the government and its employes [sic] of the sanctity of a man's home and the privacies of life. It is not the breaking of his doors, and the rummaging of his drawers, that constitutes the essence of personal security, personal liberty and private property, where that right has never been forfeited by his conviction of some public offence—it is the invasion of this sacred right which underlies and constitutes the essence of Lord Camden's judgment.").

11. Justice Douglas, writing for a plurality of the Court, collected various established constitutional doctrines that could be considered to protect an interest in privacy—the first, third, fourth, fifth, ninth, and fourteenth amendments—then concluded that their sum resulted in a "penumbral" privacy right. 381 U.S. at 484. Justice Goldberg, on the other hand, in a concurring opinion, chose to view the right of privacy as a fundamental personal liberty that is protected from abridgement by the federal government or the states by the fifth and fourteenth amendments, as supported by the ninth amendment. *Id.* at 492-93.

12. 410 U.S. 113 (1973).

13. Justice Blackmun, delivering the opinion of the Court, stated that the right of privacy is founded in the fourteenth amendment's concept of personal liberty and restrictions on state action and is broad "enough to encompass a woman's decision whether or not to terminate her pregnancy." *Id.* at 153.

14. *See* Note, *Privacy in the First Amendment*, 82 YALE L.J. 1462, 1475-76 (1973).

15. "[I]t is apparent *that* the right of privacy is constitutionally protected. It is *when* and *how* which create the problems." Roberts v. Clement, 252 F. Supp. 835, 848 (E.D. Tenn. 1966) (Darr, J., concurring).

16. Both the *Griswold* and *Roe* cases fall into this category. *See also* Camara v. Municipal Court, 387 U.S. 523 (1967) (administrative search of the home); Murphy v. Houma Well Serv., 413 F.2d 509 (5th Cir. 1969) (search of parentage to determine legitimacy of children for priorities under will not allowed); Babbitz v. McCann, 310 F. Supp. 293 (E.D. Wis. 1970) (woman has private right to decide whether to bear her unquickened child); Buchanan v.

of this right to other areas.[17] Whether the family relationship is at issue or not, however, a balancing test has evolved and is applied when valid governmental purposes are in conflict with established constitutional rights.[18] If the constitutional right concerned is found to be fundamental, a strict standard is applied, and the state is required to come forward with overwhelming justification for its action—a compelling state interest.[19] To a large extent, whether or not the right is fundamental is often determinative of whether the state action will be sustained. Moreover, the waiver of a fundamental right must meet the strict test of being "voluntary, knowing, and intelligently made."[20] While student rights in general have been the subject of much litigation dealing with the existence of various fun-

Batchelor, 308 F. Supp. 729 (N.D. Tex. 1970) (sodomy law declared unconstitutional after a consenting, married couple challenged it).

17. *See, e.g.*, Smayda v. United States, 352 F.2d 251 (9th Cir. 1965), *cert. denied*, 382 U.S. 981 (1966) (accused does not have same rights in public toilet as he would have in his own home); Thom v. New York Stock Exch., 306 F. Supp. 1002 (S.D.N.Y. 1969) (law requiring fingerprinting as a prerequisite to employment with SEC related firms upheld); City of Carmel-by-the-Sea v. Young, 2 Cal. 3d 259, 466 P.2d 225, 85 Cal. Rptr. 1 (1970) (statute requiring disclosure of financial interests of public officials is an unconstitutional invasion of right of privacy); 23 VAND. L. REV. 1359 (1970); note 24 *infra*.

18. *See, e.g.*, Roe v. Wade, 410 U.S. 113 (1973) (private right to terminate pregnancy held superior, within certain limits, to state's interest in protecting parental life); Griswold v. Connecticut, 381 U.S. 479 (1965) (marital privacy superior to state purpose of controlling use of contraceptives); McLaughlin v. Florida, 379 U.S. 184 (1964) (state purpose of preventing breaches of basic concepts of sexual decency must yield when it discriminates racially); NAACP v. Alahama, 377 U.S. 288 (1964) (state requirements for corporate registration supply no basis for mandatory disclosure of all members of corporate organization); Shelton v. Tucker, 364 U.S. 479 (1960) (state concern for competency and fitness of teachers held not sufficient to require disclosure of all organizational memberships of individual teachers); Bates v. City of Little Rock, 361 U.S. 516 (1960) (local ordinance regulating corporations held not sufficient to require disclosure of all members of corporate association); Barenblatt v. United States, 360 U.S. 109 (1959) (balancing of public and private interests when first amendment rights present).

19. This approach to balancing especially was evident in *Roe*, in which the Court found the state's interest in the health of the mother to be compelling only after the first trimester of pregnancy, at which time the mortality rate in abortion starts to exceed the mortality rate in natural childbirth, and after this point, a state may regulate the abortion procedure to the extent that the regulation reasonably relates to the preservation and protection of the health of the mother. After the second trimester, the state's interest in the then viable unborn child becomes compelling, and the state is given even greater latitude in its actions, to the point of being able to proscribe abortion during that period except when it is necessary to preserve the health or life of the mother. 410 U.S. at 163-64. A similar approach is followed in the area of equal protection.

20. D.H. Overmyer Co. v. Frick Co., 405 U.S. 174, 185 (1972) (assumed same standard for waiver in a property right case as in a criminal case). *See also* Fuentes v. Shevin, 407 U.S. 67, 95 (1972) ("[A] waiver of constitutional rights in any context must, at the very *least*, be clear."); Brady v. United States, 397 U.S. 742, 748 (1970) (criminal context: "Waivers of constitutional rights . . . must he knowing, intelligent acts done with sufficient awareness of the relevant circumstances and likely consequences.").

damental rights and their balancing with the *in loco parentis*[21] power of the school, the question of a student's right of privacy has been litigated infrequently. The principal case upholding student rights, *Tinker v. Des Moines School District*,[22] was decided on the basis of the first amendment protection of freedom of expression,[23] and the most frequently litigated area of student rights, that of the "long hair" cases, only in a few instances has been argued on the basis of a constitutionally protected right of privacy, with inconsistent results based substantially on whether the concept of privacy applied rather than on whether a fundamental right of privacy existed.[24] Generally, however, whatever the right asserted by the student in opposition to the powers of the school board, a balance consistently has been struck after determining whether a fundamental right is concerned and whether the school board consequently

21. It is generally recognized that schools have certain discretionary powers over the students in their charge, commonly referred to as their *in loco parentis* power, which invests them with many of the rights, duties, and responsibilities of a parent.

22. 393 U.S. 503 (1969).

23. Students, including the plaintiff, planned to wear black armbands to school in protest of the hostilities in Viet Nam. The principals of the schools became aware of the plan and adopted a policy that participating students would be asked to remove the armbands, and if a student refused, he would be suspended until he returned without it. The district court held the measure constitutional as reasonable in order to prevent disturbance of school discipline. The Supreme Court, Justice Fortas writing for the majority, found the fundamental first amendment freedom of speech and expression at issue and therefore applied a stricter standard of justification for the school action, holding the action violative of that right and therefore unconstitutional: "It can hardly be argued that either students or teachers shed their constitutional rights to freedom of speech or expression at the school house gate." *Id.* at 506.

24. *See, e.g.*, Richards v. Thurston, 424 F.2d 1281, 1283 (1st Cir. 1970) (expansion of right of marital privacy of *Griswold* to include student who wore his hair "falling loosely about the shoulders" rejected); Jackson v. Dorrier, 424 F.2d 213, 218 (6th Cir.), *cert. denied*, 400 U.S. 850 (1970) (contention by students and their parents that constitutional right of privacy was impaired by school board's prohibition of male students' long hair held without merit); Breen v. Kahl, 419 F.2d 1034 (7th Cir. 1969), *cert. denied*, 398 U.S. 937 (1970) (right to wear one's bair at any desired length is an ingredient of personal freedom whether it is designated as being within the "penumbras" of *Griswold* or the additional fundamental rights encompassed within the ninth amendment); Black v. Cothren, 316 F. Supp. 468 (D. Neb. 1970) (fundamental right of privacy no longer open to question, and that right includes wearing one's hair at the length and in the manner he chooses).

More often the question of privacy in a school situation has come up in a fourth amendment search and seizure context. The courts have been divided as to whether searches by school officials are subject to the restrictions of the fourth amendment. *See, e.g.*, State v. Baccino, 282 A.2d 869 (Del. Super. Ct. 1971) (fourth amendment restrictions apply but "reasonable suspicion" sufficient justification due to *in loco parentis* doctrine); People v. Stewart, 313 N.Y.S.2d 253 (N.Y. City Crim. Ct. 1970) (school administrator not acting in concert with the police is a private person to whom fourth amendment prohibitions do not apply); Phay, *Pupils*, in THE YEARBOOK OF SCHOOL LAW 1972 ¶ 6.3 (1972).

must come forward to show a compelling interest.[25] The right of privacy as it relates to psychological tests and the confidentiality of the resulting information has been a subject of concern on a number of fronts,[26] but this concern has produced no significant litigation.[27] In 1965, only two days after the Supreme Court delivered its decision in *Griswold* expanding the constitutional protection of privacy, the Senate Subcommittee on Constitutional Rights heard testimony relating to the psychological testing of federal government employees.[28] The inquiry directed itself to the constitutional propriety of the areas to which the psychological-test questions are directed,[29] the reliability of the test results,[30] and the problems of confidential-

25. *See* cases cited in E. BOLMEIER, LEGAL LIMITS OF AUTHORITY OVER THE PUPIL (1970); E. BOLMEIER, THE SCHOOL IN THE LEGAL STRUCTURE 223-94 (2d ed. 1973); L. PETERSON, R. ROSSMILLER, & M. VOLZ, THE LAW AND PUBLIC SCHOOL OPERATION 371-427 (1968); Phay, *supra* note 24; Sealey, *The Courts and Student Rights—Substantive Matters*, in EMERGING PROBLEMS IN SCHOOL LAW 23-50 (1972).

26. Justice Brandeis was one of the first to voice this concern in his dissenting opinion in Olmstead v. United States, 277 U.S. 438, 471 (1928). Justice Brandeis predicted that "[a[dvances in the psychic and related sciences may bring means of exploring unexpressed beliefs, thoughts and emotions." *Id.* at 474. He than asked, "Can it be that the Constitution affords no protection against such invasions of individual security?" *Id.* He subsequently answered his own question:

> The makers of our Constitution undertook to secure conditions favorable to the pursuit of happiness. They recognized the significance of man's spiritual nature, of his feelings, and of his intellect. . . . They sought to protect Americans in their beliefs, their thoughts, their emotions and their sensations. They conferred, as against the Government, the right to be let alone—the most comprehensive of rights and the most valued by civilized men. To protect that right, every unjustifiable intrusion by the Government upon the privacy of the individual, whatever the means employed, must be deemed a violation of the Fourth Amendment.

Id. at 478.

27. *See* Sherrer & Roston, *Some Legal and Psychological Concerns About Personality Testing in the Public Schools*, 30 FED. B.J. 111 (1971).

28. *Hearings on Psychological Testing Procedures and the Rights of Federal Employees Before the Subcomm. on Constitutional Rights of the Senate Comm. on the Judiciary*, 89th Cong., 1st Sess. (1965) [hereinafter cited as *Hearings*].

29. Monroe H. Freedman, associate professor of law at George Washington University, consultant to the Educational Testing Service, and member of the Test Development and Research Committee of the Law School Admission Test, testified that people answering some of the questions contained in one of the most widely-used psychological tests, the Minnesota Multiphasic Personality Inventory, were clearly not "secure in their persons" within the meaning of the fourth amendment. *Id.* at 172.

30. Martin L. Gross, author of *The Brain Watchers*, in his testimony before the subcommittee quoted Dr. John Dollard, professor of psychology at Yale University: "There may be exceptions unknown to me, but generally speaking, projective tests, trait scales, interest inventories, or depth interviews are not proved to be useful in selecting executives, or salesmen, or potential delinquents, or superior college students. If not known to be reliable and valid, personality tests should be absolutely avoided because they can do much harm." *Id.* at 33. Mr. Gross went on to state that such tests were "inaccurate and dangerous psychological tools." *Id.* at 42.

ity to which this information would be subject.[31] Later, the chairman of that subcommittee wrote that Congress has received complaints of government invasions of privacy in the form of "intrusive questionnaires unnecessary to the needs of government" and of psychological tests; the chairman concluded that the majority of these grievances constitute violations of constitutional guarantees contained in the first, fourth, and fifth amendments.[32]

The instant court first addressed plaintiffs' contention that the allegedly involuntary program was a violation of their right of privacy.[33] While recognizing that *Griswold* and *Roe* did establish such a constitutionally protected right, the court did not feel it necessary to expand the interpretation of those cases' precedential value beyond the family relationship context in which they were decided. Consequently, the court examined the instant factual situation as it related to family relationships and child rearing, finding the questionnaire to be highly personal in nature and designed to probe directly into the individual's family relationship. The court concluded that it could look upon any invasion of the family relationship as a violation of the constitutional right of privacy. Next, the court dismissed any notion that plaintiff child's status as a student and a minor would invalidate his constitutional right of privacy. The court stated that the right of privacy should be protected with the same deference as was the right of speech in *Tinker*[34] and that students are entitled to exercise their constitutional rights. Whether parents can waive the child's constitutional rights without his consent was the next question facing the court, but it did not deem it necessary to provide an answer at this time. Instead, the court concluded that the information in the parental consent letters by the school board was not sufficient to constitute the "informed consent" required for waiver of constitutionally protected rights; the letters were characterized as "selling devices" that failed to mention potential negative effects of the testing.[35] Finding little precedent regarding personality testing and its confidentiality, the court nevertheless

31. *Id.* at 176. *See also* Countryman, *The Diminishing Right of Privacy: The Personal Dossier and the Computer*, 49 TEXAS L. REV. 837 (1971).

32. Ervin, *Privacy and the Constitution*, 50 N.C.L. REV. 1016, 1017 (1972).

33. The court later addressed plaintiffs' contention that other constitutional rights would be violated by the CPI program. *See* note 4 *supra*. It concluded, however, that the program would violate no constitutional rights except that of privacy.

34. *See* notes 22 and 23 *supra* and accompanying text.

35. *See* note 20 *supra*. The court noted that the letters sent to parents only presented the affirmative side of the picture concerning the tests, purposely not mentioning possible stigmatizing, scapegoating, or confidentiality problems.

stated that some of the problems about which the parents were not informed were so potentially harmful that the standard for informed consent ought to be comparable to that obtained by a doctor prior to surgery. The court expressed doubts as to the veracity of the test results and the qualifications of the personnel administering the program and stated that the alleged confidentiality of the information was lost as soon as it was reported to the school superintendent. The court considered the possible "labelling" of the child to be the most serious problem presented, given the lack of confidentiality and the lack of experience among those administering the program. Potentially permanent damage to the child, the court felt, might be created by stigmatization among peers and by a "self-fulfilling prophecy" potentiality—the tendency of a child labelled as a potential drug user to decide to conform to that label. The magnitude of this danger led the court to conclude that the margin of error of such a program would have to be "almost nil"[36] for the student to be adequately protected. Reasoning that a balancing test was in order because an invasion of privacy was at issue, the court weighed the recognized dangers of the program against the asserted discretionary power of a school board to act and held that through the CPI program the individual would stand to lose more than society would gain in its fight against drugs. Finding that the school board had not sustained its burden of showing a compelling interest that outweighed plaintiffs' right of privacy, the court enjoined the program for failing to meet constitutionally demanded standards.

The instant court cautiously restricted its discussion of the constitutionally protected right of privacy to the realm of family relationships,[37] putting substantial emphasis on the intimate nature of the questions in the CPI questionnaire and their relation to the family. Therefore, while the court at first glance would seem to have recognized a student's right of privacy, it in reality only finds a violation of the right of familial privacy—one member of the family being a student. In fact, the court specifically avoids the more potent question of plaintiff student's own rights, both as to the right of privacy itself and as to whether his parents could waive his rights without his consent. In the area of student rights, this decision undoubtedly will join the long list of cases supporting the proposition that student rights, at least when they concern fundamental freedoms, outweigh the *in loco parentis* discretionary power of a

36. 364 F. Supp. at 920.

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

school board.[38] Indeed, this is one of only a few cases in which the question of a student's right of privacy has been addressed.[39] On the other hand, the precedential value of the decision in the area of student rights is weakened for much the same reason that it is in the area of privacy—it is based substantially on the right of privacy in the family relationship rather than on the right of the individual student. Although the decision's impact on the development of the concepts of privacy and student rights is questionable, the effect of this decision on the power of a school over its curriculum may be substantial. The case reasonably could be said to stand for the proposition that when a school program threatens the fundamental right of privacy of the family, it will be held unconstitutional; therefore, the holding could be extended to prohibit other programs that represent similar invasions into the family relationship. If a personality test asking family-related questions is held to violate this right, then conceivably a sex education course might be said to constitute an equal invasion, though the instant case could be distinguished on the basis of the extraordinary potentiality of harm to the students that the court foresaw in the CPI program. The prime importance of the court's decision, however, lies in its potential impact on the field of psychological or personality testing. Certainly, drug-abuse tests are not the only psychological tests that ask probing and intimate questions; most psychological tests' expressed purpose demand that they do so.[40] They are usually designed to be answered with instantaneous, reflex responses—responses that inevitably result in an invasion of private thoughts.[41] While other psychological tests might not probe so directly or deeply into family relationships as does the CPI program, it is inevitable, given the purpose of most of these tests, that some question would be related substantially to this area, even if only indirectly. Though the finding of a lack of confidentiality in the program was a major factor in the court's holding that an invasion of constitutionally protected privacy had occurred, there is every reason to believe that similar tests would be subject to the same infirmities. Indeed, one of the major concerns of writers addressing the question of psychological testing has been the danger of the test results losing their confidentiality either by means of simple disclosures, susceptibility to subpoena power, or accessibility of the data banks on which the whole concept of many

38. *See* notes 23 and 24 *supra*. *See also* cases cited in Sealey, *supra* note 25, at 41-50.
39. *See* note 24 *supra*.
40. *Hearings*, *supra* note 28, at 170; Sherrer & Rosten, *supra* note 27, at 115.
41. *Hearings*, *supra* note 28, at 169; Sherrer & Rosten, *supra* note 27, at 111.

uniform psychological tests are predicated.[42] Thus, while the instant decision only somewhat broadens the scope of family-relationship privacy and merely lends support to other decisions affording students the same fundamental constitutional rights enjoyed by other citizens, it provides perhaps the first signal that the psychological testing phenomenon, which invades the lives of literally all Americans, may not in the future enjoy the same immunity from constitutional strictures that it has in the past.

Taxation—Capital Gains—Payment to Lessor in Satisfaction of Lessee's Obligation to Restore Premises Appears to Create Taxable Gain From the Sale or Exchange of Property Pursuant to Section 1231

Taxpayer-lessor[1] reported payment received in satisfaction of a lessee's obligation to restore[2] the leased premises to their pre-lease condition[3] as long-term capital gain[4] pursuant to section 1231

42. Sherrer and Rosten in their article propose that legislation be enacted to ensure that the results of psychological tests will not be released to third parties without the informed consent of the student or his parents. Note 27 *supra*, at 114. They enumerate some of the potential problems of confidentiality: data banks (*id.* at 115-16); results becoming a permanent part of the student's record, available to employers eventually (*id.* at 116); and the problems inherent in any program instituted by the school on the basis of these results (*id.* at 117). *See also Hearings, supra* note 28, at 176.

1. Taxpayer, a corporation engaged in the trade or business of renting real estate, acquired the property in question—a building with offices and a theater—in 1944 subject to an existing lease of the theater to the Columbia Broadcasting System, Inc. (CBS), which used it for radio broadcasting purposes.

2. The lease negotiated between taxpayer and CBS in 1947 at the expiration of the prior owner's lease and all successive leases contained substantially the following restoration provision, which was included in the indenture covering the period from July 15, 1958 through December 31, 1963 and which is the subject of the payment in issue:

> Fourth: —At the expiration or other termination of the term hereby granted, the tenant shall and will leave the said premises and the theatre whole and in good order and condition . . . reasonable wear and tear and damage by the elements excepted . . . provided, however, that the tenant shall restore the premises substantially to the condition in which they existed on November 14, 1947 . . . and the tenant shall fully indemnify the landlord for every and all costs and expenses of whatsoever name or nature that may be required for the purposes of reinstating the premises to said condition.

3. CBS altered the interior of the theater extensively to convert it from a legitimate theater into one suitable for television broadcasts. Changes included removal of approximately 300-400 theater seats, all carpeting, chandeliers, and stage curtains, the extension of the stage area, a change in floor level, construction of control rooms, the installation of thousands of feet of electrical wiring, and the alteration of bathrooms and the heating system.

4. Prior to December 31, 1963, CBS determined as a matter of corporate policy to

of the Internal Revenue Code,[5] which provides capital gains treatment for gains from the sale, exchange, or involuntary conversion of certain property used in the trade or business of the taxpayer.[6] Taxpayer contended that the transaction constituted a "sale or exchange" as an alternative to its other argument that the payment compensated for the destruction and removal of parts of the premises and therefore qualified as gain derived from involuntary conversion of the property.[7] Rejecting taxpayer's contentions,[8] the Tax Court[9] characterized the payment as consideration for modification[10] of the lessee's contractual obligation to restore the premises

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eliminate or update restoration clauses from leases it held for theaters in New York because of concern over rising construction costs, which made it difficult to predict the ultimate cost of fulfilling its obligation to restore premises leased by it. In 1964 CBS negotiated with taxpayer to update the restoration clause in the upcoming new lease and to settle on an amount needed to restore the theater from its current to its 1947 condition. The parties agreed on $125,000 as a compromise figure. The adjusted basis of the entire building at the time of the settlement was $93,333.51; taxpayer reported the excess of the payment over the adjusted basis of $31,666.49 as long-term capital gain.

5. INT. REV. CODE OF 1954 § 1231.

6. Section 1231 of the Internal Revenue Code of 1954 provides in relevant part:

> (a) *General rule.* —If, during the taxable year, the recognized gains on sales or exchanges of property used in the trade or business, plus the recognized gains from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) of property used in the trade or business and capital assets held for more than 6 months into other property or money, exceed the recognized losses from such sales, exchanges, and conversions, such gains and losses shall be considered as gains and losses from sales or exchanges of capital assets held for more than 6 months.

The definition of "property used in the trade or business" is provided in subsection (b):

> (1) *General rule.* —The term 'property used in the trade or business' means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 6 months, and real property used in the trade or business, held for more than 6 months, which is not—(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year; (B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business; or, (C) a copyright, a literary, musical, or artistic composition, or similar property, held by a taxpayer described in paragraph (3) of Section 1221 . . . .

7. Taxpayer had initially reported the gain on its corporate tax return as long-term capital gain resulting from involuntary conversion of the property.

8. The Tax Court peremptorily dismissed taxpayer's contention that the property had been involuntarily converted, finding instead that the taxpayer voluntarily had agreed to the conversion of its property. The court was further unable to find a sale or exchange of anything, particularly in view of the fact that much of the property removed from the theater would have been fully depreciated prior to the negotiation of the settlement. Sirbo Holdings, Inc., 57 T.C. 530, 537-38 (1972).

9. The Commissioner had noted a deficiency in taxpayer's tax liability. Section 6213 of the Code provides that an appeal from a deficiency assessment should be taken to the Tax Court. INT. REV. CODE OF 1954, § 6213.

10. 57 T.C. at 538.

and upheld the commissioner's ruling that the payment yielded ordinary income. On appeal to the Second Circuit Court of Appeals, *held*, vacated and remanded. Payment to a lessor in satisfaction of a lessee's obligation to restore leased premises to pre-lease condition appears to be entitled to capital gains treatment as a sale or exchange of property pursuant to section 1231 of the Internal Revenue Code.[11] The court reserved its final decision, however, pending resolution by the Tax Court of the latter's inconsistent treatment of restoration payments. *Sirbo Holdings, Inc. v. Commissioner*, 476 F.2d 981 (2d Cir. 1973).

The preferential tax treatment accorded gains from certain transfers of business property under section 1231 has occasioned extensive litigation over what constitutes a "sale or exchange,"[12] particularly when the property allegedly sold or exchanged is an intangible such as a contract right.[13] While courts generally have

11. The court agreed with the Tax Court that taxpayer had failed to establish involuntary conversion. Judge Friendly reasoned that the conversion was voluntary in 2 respects: first, in that taxpayer had leased the property willingly to CBS with the understanding that it might he converted for use into a television studio; and secondly, in that the taxpayer had agreed to accept a cash payment rather than enforce the restoration clause. 476 F.2d at 985-86. The court relied on hoth indications of voluntariness in distinguishing the instant case from those on which taxpayer relied: United States v. Pate, 254 F.2d 480 (10th Cir. 1958) (destruction of taxpayer's building under circumstances heyond his control—through negligence of another—constituted involuntary conversion); Grant Oil Tool Co. v. United States, 381 F.2d 389 (Ct. Cl. 1967) (irretrievable loss of oil-drilling tools by lessee constituted involuntary conversion); Walter A. Henshaw, 23 T.C. 176 (1954) (damage to oil leases through negligence of third party constituted involuntary conversion); Guy L. Waggoner, 15 T.C. 496 (1950) (taxpayer's property damaged while leased to the United States under threat of condemnation involuntarily converted).

12. The courts have been forced to determine judicially the transactions covered by the "sale or exchange" language because of congressional failure to define the phrase anywhere in the Internal Revenue Code. *See, e.g.*, Commissioner v. P.G. Lake, Inc., 356 U.S. 260 (1958) (assignment of oil payment right in return for $600,000 not a sale or exchange); Sanders v. Commissioner, 225 F.2d 629 (10th Cir. 1955) (release of claim for damages in return for payment not a sale or exchange); Commissioner v. Golonsky, 200 F.2d 72 (3d Cir.), *cert. denied*, 345 U.S. 939 (1952) (surrender of lease by tenant in return for payment by lessor a sale or exchange); Jones v. Corbyn, 186 F.2d 450 (10th Cir. 1950) (release of exclusive insurance agency contract for payment a sale); Philadelphia Quartz Co. v. United States, 374 F.2d 512 (Ct. Cl. 1967) (cancellation of liability of bailee for return of steel drum in return for deposit a sale); Hamilton & Main, Inc., 25 T.C. 878 (1956) (cancellation of lessee's duty to restore leased premises to pre-lease condition for payment a sale); Nehi Beverage Co., 16 T.C. 1114 (1951) (cancellation of agent's liability for pop bottles in return for deposits not a sale). For general discussions of the problems of the capital gains-ordinary income dichotomy see Surrey, *Definitional Problems in Capital Gains Taxation*, 69 HARV. L. REV. 985 (1956); Comment, *The Troubled Distinction Between Capital Gain and Ordinary Income*, 73 YALE L.J. 693 (1964).

13. *See, e.g.*, Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir.), *cert. denied*, 357 U.S. 919 (1958) (surrender of exclusive purchasing right for payment not a sale or exchange); Jones v. Corbyn, 186 F.2d 450 (10th Cir. 1950); Hamilton & Main, Inc., 25 T.C. 878 (1956).

recognized that a contract right is "property" within the broad sense of the word,[14] they have utilized two different approaches to analyze the "sale or exchange" requirement.[15] The first, which focuses on the nature of the contract right being considered, is applied to determine whether the contract right allegedly sold constituted an independent interest in an underlying capital asset. The more traditional approach, typified by *Commissioner v. Starr Brothers*,[16] focuses, however, on the survival of the contract right as valuable property after its transfer. Generally, utilization of this latter approach has proved fatal to a taxpayer attempting to show a sale or exchange in that the courts have characterized the transaction as a release of an obligation that extinguishes rather than transfers any rights.[17] The Second Circuit traditionally subscribed to the survival approach, which denies capital gains treatment to payments for contract rights such as cancellation of leases[18] and distributors agreements,[19] until it rendered its decision in *Commissioner v. Ferrer*.[20] The taxpayer in *Ferrer*, who held a lease on the exclusive dramatic production rights to a novel, released his rights in return for a stated percentage of the film proceeds. In determining whether the proceeds received constituted capital gain or ordinary income under the predecessor to section 1221 of the 1954 Code,[21] Judge

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See also Chirelstein, *Capital Gain and the Sale of a Business Opportunity: The Income Tax Treatment of Contract Termination Payments*, 49 MINN. L. REV. 1 (1964); Note, *Distinguishing Ordinary Income from Capital Gain Where Rights to Future Income are Sold*, 69 HARV. L. REV. 737 (1956).

14. *See, e.g.*, Commissioner v. Gillette Motor Transport, Inc., 364 U.S. 130, 134-35 (1960); Commissioner v. Starr Bros., Inc., 204 F.2d 673, 674 (2d Cir. 1953); Jones v. Corbyn, 186 F.2d 450, 453 (10th Cir. 1940).

15. *See* Eustice, *Contract Rights, Capital Gain, and Assignment of Incomes—the Ferrer Case*, 20 TAX L. REV. 1, 6-7 (1964). *But see* Chirelstein *supra* note 13 (finds 3 basic approaches to the problems).

16. 204 F.2d 673 (2d Cir. 1953). The taxpayer in *Starr Bros.* released an exclusive dealership right in return for a cash payment. The court found no sale or exchange because the contract rights "were not transferred to the promisor; they merely came to an end and vanished." *Id.* at 674.

17. Commissioner v. Pittston Co., 252 F.2d 344 (2d Cir. 1958) (payment for surrender of exclusive right to buy coal extinguished rather than transferred right); General Artists Corp. v. Commissioner, 205 F.2d 360 (2d Cir. 1953) (assignment of exclusive booking-agency contract to new agent, who wrote new contract with performer, released rather than transferred rights).

18. Hort v. Commissioner, 313 U.S. 28 (1941).

19. *See, e.g.*, Leh v. Commissioner, 260 F.2d 489 (9th Cir. 1958) (surrender of gasoline requirements contract in return for payment not a sale or exchange); Commissioner v. Starr Bros., Inc., 204 F.2d 673 (2d Cir. 1953).

20. 304 F.2d 125 (2d Cir. 1962).

21. INT. REV. CODE OF 1939, § 117(a), (now INT. REV. CODE OF 1954, § 1221).

Friendly rejected the traditional survival test and focused instead on the nature of the contract rights held by the taxpayer before transfer. Partially basing his rejection of the survival test on apparent congressional disapproval of prior Second Circuit decisions,[22] Judge Friendly suggested that classification of a contract right as property capable of being sold or exchanged should be determined by the existence of an equitable interest or estate in specific property[23] and held that the motion picture production right constituted an equitable interest capable of sale. Speculation that *Ferrer* marked a turning point in the Second Circuit's treatment of the sale or exchange of contract rights[24] was diminished substantially when the court apparently returned to the survival test in *Billy Rose's Diamond Horseshoe, Inc. v. United States.*[25] Taxpayer in *Billy Rose* leased its building to the National Broadcasting Company for use as a television theater, including in the lease a provision that required the lessee to restore the theater to its pre-lease condition upon termination of the lease. Prior to expiration of the lease, the parties compromised on $300,000 as the value of the property removed and as satisfaction for extensive alterations made to the interior of the theater by the lessee. The restoration payments having been made with a series of notes on account, the taxpayer attempted to report the income from the notes on the installment basis as provided by section 453(b) of the Internal Revenue Code.[26] Applying the survival test, the court held that the transaction did not constitute a "sale or other disposition" of personal property as required by section 453 and therefore could not be reported on the installment basis. Although section 453 refers to "sales or other dispositions" and section 1231 is couched in terms of "sales or exchanges," the court indicated that the test for both should be the same and distinguished *Ferrer* on the grounds that it involved the release of a substantial contract right that could be sold to a third party whereas the right to restoration in *Billy Rose* had no value to

22. The Internal Revenue Code of 1954 included a new provision, § 1241, which provides that amounts received by a lessee for the cancellation of a distributor's agreement should be considered as amounts received in exchange for that lease or agreement.

23. 304 F.2d at 130.

24. Chirelstein, *supra* note 13, at 19-25; Eustice, *supra* note 15, at 4-15.

25. 448 F.2d 549 (2d Cir. 1971). For comments on *Billy Rose* see Case Note, 14 BOS. COL. IND. & COM. L. REV. 183 (1972); *Second Circuit Note—1970 Term*, 47 ST. JOHN'S L. REV. 415 (1972).

26. Section 453 generally provides that a taxpayer who sells or otherwise disposes of property on the installment plan may report his income in the year in which it is received as long as the payments received in the year of sale do not exceed 30% of the selling price. INT. REV. CODE OF 1954, § 453.

parties other than the lessee and lessor.[27] Despite *Billy Rose*'s indication that the release of a right to restoration is not a sale under sections 453 and 1231 of the Internal Revenue Code, the Tax Court has held in a recent decision, *Boston Fish Market Corp.*,[28] that capital gains treatment should be accorded to restoration payments and noted that these payments generally have "been regarded as having been received in sale or exchange of the unrestored property."[29]

Having initially agreed with the Tax Court that taxpayer had failed to establish an involuntary conversion of its property into money,[30] the instant court turned to consider the alternative contention that the transaction constituted a sale or exchange of property used in the trade or business. Judge Friendly, speaking for the court, first disapproved of the Tax Court's reliance on *Billy Rose*,[31] asserting that the Second Circuit's declaration that the survival test would apply to preclude capital gains treatment under either section 453 or section 1231 was too narrow an approach, at least as applied to section 1231. He noted that the covenant to restore, which could not qualify as property used in taxpayer's trade or business, was not the sole basis of the capital gains claim, thus making the extinguishment of that obligation nondeterminative. Instead, he reasoned that the claim was based in part on the ground that the restoration payment was compensation for the removal and destruction of leased property over the years. If that compensation had been provided for literally in the lease, in lieu of the restoration clause, it would have been treated as proceeds from a sale or exchange.[32] To accord different treatment to substantially identical transactions would, he concluded, seem to be an adherence to form over substance. Secondly, the court found the inconsistent results reached by the Tax Court in the instant case and in *Boston Fish Market*, which was decided two months later,[33] to be unacceptable.[34]

27. 448 F.2d at 552.

28. 57 T.C. 884 (1972).

29. *Id.* at 889. In support of its statement, the court cited Washington Fireproof Bldg. Co., 31 B.T.A. 824 (1934), and Hamilton & Main, Inc., 25 T.C. 878 (1956), which held that restoration payments made to a lessor in satisfaction of the lessee's obligation to restore were received from the sale or other disposition or the sale or exchange of a capital asset.

30. *See* note 11 *supra.*

31. *See* text accompanying notes 25-57 *supra.*

32. Judge Friendly cited Washington Fireproof Bldg. Co., 31 B.T.A. 824 (1934), and Hamilton & Main, Inc., 25 T.C. 878 (1956), in support of his statement. *See* note 29 *supra.*

33. Taxpayer moved immediately for reconsideration after the decision in *Boston Fish Market*, but its motion was denied without explanation.

34. The court found the inconsistency unacceptable on grounds that the Commissioner

Speculating that the Tax Court's reliance on *Billy Rose* in the instant case and its subsequent failure to reconcile its instant decision with *Boston Fish Market* resulted from that court's previous ruling that under certain circumstances it would be bound by decisions of a court of appeals,[35] Friendly suggested that *Billy Rose* was not binding on the Tax Court in the instant case. Pointing out that *Billy Rose* dealt with the interpretation of "the sale or other disposition of property" as employed in section 453 rather than with "sale or exchange" as employed in section 1231, the court reasoned that Congress might have intended different meanings for the two phrases, particularly in light of the different purposes of the two provisions.[36] Moreover, the instant court expressly termed as dicta the language of *Billy Rose* that similarly construed the "sale or other disposition" and "sale or exchange" requirements. Finally, Friendly observed that the inconsistency in approach to the transfer of contract rights in *Ferrer* and *Billy Rose* would demand perhaps en banc consideration by the instant court. He felt, however, than any en banc proceedings should be delayed to allow the Tax Court to resolve its contradictory decisions in *Boston Fish Market* and the instant case free of the self-imposed restraints of *Billy Rose.*[37]

Although the instant decision lacks the impact of a clear holding, it is a significant indication that within the Second Circuit the basic conflict between the two analytical approaches for determining the character of gain resulting from a transfer of contract rights has not been resolved in favor of the survival test, as *Billy Rose* seemed to imply.[38] Rather, in an obscure opinion, Judge Friendly

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has a duty to treat similarly situated taxpayers consistently—he cannot concede capital gains treatment in *Boston Fish Market* and dispute it in the instant case when both have almost identical facts—and because the opinion in *Boston Fish Market* stated specifically that restoration payments "have generally been regarded as having been received in the sale or exchange of the unrestored property." 57 T.C. at 889.

35. Jack E. Golson, 54 T.C. 742 (1970). "It is our best judgment that better administration requires us to follow a court of appeals decision which is squarely in point where appeal from our decision lies to that court of appeals and to that court alone." *Id.* at 750.

36. The court, noting that the § 453 installment sales provision was to be strictly construed, cited Murray v. United States, 426 F.2d 376, 381 (Ct. Cl. 1970), as authority for the proposition that the section does not characterize the nature of the gain in question but merely defers the reporting of certain taxable gain. 476 F.2d at 988.

37. Although the court indicated that it agreed with taxpayer's characterization of the proceeds as capital gain, Judge Friendly stated in a footnote to the opinion that taxpayer's attempt to use its basis for the entire building to determine the amount of gain was unwarranted. 476 F.2d at 989 n.9. He felt that taxpayer's basis should be allocated as in *Boston Fish Market*, in which the Tax Court held that proceeds received in lieu of restoration were "taxable to the extent that they exceeded the undepreciated basis of the leasehold improvements destroyed, removed, or disconnected by the lessee." 57 T.C. at 889.

38. *See* Case Note, *supra* note 25, at 184, 192.

implicitly reasserted his adherence to the equitable interest test formulated in *Ferrer*. The obscurity of the opinion results from its treatment of several problems, the first being the inconsistent treatment accorded restoration payments by the Tax Court in *Boston Fish Market* and the instant case. The erratic treatment of these payments by the Tax Court normally would be a matter for its own resolution, but Friendly effectively ordered the Tax Court to harmonize the results in the instant case and in *Boston Fish Market* by eliminating any grounds for reliance on *Billy Rose*. By distinguishing the "sale or other disposition" requirement at issue in *Billy Rose* and the "sale or exchange" requirement in the instant case, Friendly confined the holding of *Billy Rose* to section 453 cases. The narrow interpretation thus given *Billy Rose* by Friendly effectively limited its impact just as Judge Hay's narrow interpretation of the holding of *Ferrer* in *Billy Rose* severely limited the impact of the equitable interest approach.[39] The distinction drawn between the Second Circuit's analysis of section 453 and section 1231 transactions for tax purposes seems, therefore, to be based not on considered judicial reasoning, but on the conflict between individual judges' attitudes toward the analysis of the disposition of contract rights. Regarding the conflict in the circuit, the instant decision is particularly interesting in that Judge Friendly cites *Ferrer* only briefly. The opinion studiously avoids discussion of *Ferrer* and fails to analyze the case in terms of *Ferrer*'s equitable interest test, possibly to avoid establishing an absolute split within the circuit. The effect of the decision, however, is merely to postpone the inevitable en banc proceedings necessary to resolve the conflict and, in the meantime, to encourage the various elements in the circuit to interpret previous cases to suit individual theories. The absence of a clearly definitive distinction in the Second Circuit between a section 453 "sale or other disposition" and a section 1231 "sale or exchange" is a function of the more basic conflict among courts that can be attributed in part to lack of congressional initiative in delineating the boundaries of these two phrases. The failure of Congress to define either phrase[40] and its seemingly interchangeable use of the phrases in the Code[41] have created a problem of statutory interpre-

39. *See* text accompanying note 27 *supra*.

40. *See* note 12 *supra*.

41. For example, § 1001 applies the phrase "sale or other disposition of property" when designating occasions for computing gain or loss from property transactions but speaks of a "sale or exchange" when discussing the recognition of gains or losses in § 1001(c). INT. REV. CODE OF 1954, § 1001. *See* Comment, *supra* note 12, at 701-04.

tation for the judiciary. In several instances, Congress has enacted provisions expressly including specific transactions within definitional limits;[42] obviously, the most immediate and effective cure for the circuits' conflict would be an express inclusion or exclusion of restoration payments. Future en banc consideration of the conflict between *Ferrer* and *Billy Rose* seems, however, to be the most certain means for resolution of the problem in the immediate future.

Uniform Commercial Code — Suretyship — Surety's Equitable Priority in Defaulting Contractor's Retained Proceeds Does Not Extend to Contractor's Personal Property

Plaintiff surety brought a declaratory judgment action[1] to determine priorities between the surety and defendant bank-lender[2] to proceeds from the sale of a defaulting contractor's personal property.[3] The surety contended that completion of its suretyship obligations under performance bonds upon default of the contractor[4] cre-

42. For example, Congress provided that a transfer of a patent or an undivided interest therein will be considered the sale or exchange of a capital asset held for more than 6 months. INT. REV. CODE OF 1954, § 1235. *See also* note 22 *supra*.

1. Declaratory Judgment Act, 28 U.S.C. §§ 2201-02 (1970).

2. The primary parties that this comment discusses are the plaintiff surety, Aetna Casualty and Surety Company (Aetna), and one of 2 defendant banks, the National Bank of South Dakota (NBSD). The other bank, Northwestern National Bank (NWB), also claims priority to the proceeds, but since the perfected security interest of NBSD in the contractor's personal property is held superior to that of NWB, this comment eliminates the latter from discussion. Therefore, this comment focuses on the primary issue of the conflict between the surety and the lender (NBSD), and discusses only peripherally the collateral issue of priorities between the 2 banks. *See* note 11 *infra*.

3. The personal property involved was the contractor's equipment. Under the performance bond applications, the contractor assigned to Aetna as surety "all rights, title and interest in and to all tools, plant, *equipment* and materials of every nature and description that the said [contractor] may now or hereafter have upon said work, or in or about the site thereof, or used in connection with the work and located elsewhere . . . ." (empbasis added). No steps were taken by Aetna to perfect its interest under Article 9 of the UCC, NBSD had established a line of credit with the contractor, and had financed numerous equipment purchases. On January 25, 1968, the contractor entered into a security agreement with NBSD whereby NBSD obtained a security interest in equipment, as well as other specific property. The agreement also contained an after-acquired property clause, giving NBSD a security interest in all other equipment subsequently acquired by the contractor. This security agreement was perfected by the appropriate filing of a financing statement in accordance with Part 4 of Article 9 of the Code.

4. The surety normally furnishes either performance or payment bonds, or both, in these construction project arrangements in order to guarantee the contractor's completion of

ated a prevailing equitable lien[5] upon the proceeds. Surety maintained alternatively that even if its claim under the bond application provisions[6] constituted a security interest under the Uniform Commercial Code,[7] the secured transaction provisions of the Code did not apply.[8] Arguing that the UCC properly governs this surety-lender conflict, defendant bank-lender, who had taken a security interest in the contractor's equipment to secure loans, asserted that it acquired priority over the surety[9] in the equipment sale proceeds by perfecting its security interest in the contractor's personal property in accordance with the applicable UCC provisions.[10] The United States District Court for the District of South Dakota, *held*, judgment for the defendant.[11] When a surety and a lender are assigned rights in the same personal property of a defaulting contractor under a bond application and a security agreement respectively, the UCC governs; the secured lender who has perfected his security interest in the property under the Code takes priority over the surety who asserts equitable claims arising from completion of its bond obligations. *Aetna Casualty & Surety Co. v. J.F. Brunken & Sons, Inc.*, 357 F. Supp. 290 (D.S.D. 1973).

The traditional conflict between a defaulting contractor's surety and a commercial creditor continues to provide a prolific source of litigation. Typically, the surety writes performance and payment

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the project. *See* note 12 *infra*. If the contractor fails to meet its obligations under the contract, the surety is then compelled to perform under the bond provisions.

5. For a discussion of the equitable lien and subrogation theories see note 20 *infra* and accompanying text. In the instant case, the surety relied solely upon the equitable lien doctrine. Note that the surety contends that the equitable lien relates back to the inception of the suretyship agreement.

6. *See* note 3 *supra*.

7. UNIFORM COMMERCIAL CODE § 1-201(37). Unless otherwise specified, all references to the Uniform Commercial Code will be to the 1962 Official Text with official comments.

8. Surety contends that the Code excludes its security interest from the filing and perfection provisions due to section 9-104(f) which provides: "This Article does not apply . . . to a . . . transfer of a contract right to an assignee who is also to do the performance under the contract . . . ."

9. The surety had an unperfected interest in the proceeds because it failed to file and perfect under Parts 3 and 4 of Article 9 of the UCC.

10. *See* UNIFORM COMMERCIAL CODE §§ 9-109, 9-301, 9-302, 9-401-02.

11. As to the collateral issue dealing with priority between the 2 banks, NBSD and NWB, the court employed the rule of "first to file" under § 9-312(5)(a) of the Code and held in favor of NBSD, which had filed prior to NWB. The financing statement of NBSD was identical to its security agreement except in naming and describing the collateral covered. NWB contended that NBSD's security interest should be limited to those items listed in the financing statement. The court rejected NWB's argument, however, reasoning that such a discrepancy was not determinative since NWB knew of NBSD's extensive security interest in contractor's equipment and was therefore not misled by the financing statement.

bonds to guarantee completion of a construction project by a building contractor,[12] and the lender takes an assignment of the contract rights of the contractor as security for a construction loan.[13] The conflict arises when, upon default of the contractor, the surety, pursuant to bond provisions, performs the remaining contract obligations by either completing the project, paying the outstanding claims of laborers and materialmen, or both.[14] The competing claimants then assert rights to certain funds, consisting of either earned but unpaid progress payments in the building owner's possession,[15] progress payments earned by the surety upon completion of the contractual obligations,[16] progress payments already paid to the contractor or his lender,[17] or, most frequently, a retained percentage of the contract price held by the owner as security for completion of the project and payment of outstanding claims.[18] The resulting

12. Execution of these bonds virtually always occurs when such negotiations for construction contracts take place. When dealing with government contracts moreover, such bonds are required. Miller Act, 40 U.S.C. § 270a(a)(1)-(2) (1970). *See* National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969); Home Indem. Co. v. United States, 433 F.2d 764 (Ct. Cl. 1970). Furthermore, in situations involving private contracts, such bonds are usually required and almost always are executed. *See* Framingham Trust Co. v. Gould-National Batteries, Inc., 427 F.2d 856 (1st Cir. 1970); Withers, *Surety vs. Lender: Priority of Claims to Contract Funds*, 10 WASHBURN L.J. 356, 357 (1971); Note, *Equitable Subrogation—Too Hardy a Plant to Be Uprooted by Article 9 of the UCC?*, 32 U. PITT. L. REV. 580, 581 (1971).

13. The situation usually involves a subsequent loan by a bank or other lending institution. The contractor can have an established line of credit with the lender, as in the instant case, or he may be engaging in his initial loan transaction with the lender. No one has questioned the applicability of Article 9 of the UCC to the security interest granted the lender. *See* Note, *supra* note 12, at 581-82.

14. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962); National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969); Jacobs v. Northeastern Corp., 416 Pa. 417, 206 A.2d 49 (1965) (where surety paid laborers and materialmen, doctrine of equitable suborgation applies, and surety is entitled to monies withheld by the state as successors to rights of contractor); Withers, *supra* note 12.

15. *See* United States v. Munsey Trust Co., 332 U.S. 234 (1947) (United States withheld percentages of progress payments due the contractor); National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969) (see particularly the cases cited in n.9, at 848); Trinity Univ. Ins. Co. v. United States, 382 F.2d 317 (5th Cir. 1967) (surety who completes contract has right to remaining progress payments held by government).

16. For an excellent discussion of the status of the funds over which disputes normally arise, see Rudolph, *Financing on Construction Contracts Under the Uniform Commercial Code*, 5 B.C. IND. & COM. L. REV. 245 (1964); *see* Note, *supra* note 12.

17. *See* Rudolph, *supra* note 16; Note, *supra* note 12.

18. *See* Henningsen v. United States Fidel. & Guar. Co., 208 U.S. 404 (1908); Home Indem. Co. v. United States, 433 F.2d 764 (Ct. Cl. 1970) (surety and financing institutions both claiming rights to retained funds); Scarsdale Nat'l Bank & Trust Co. v. United States Fidel. & Guar. Co., 264 N.Y. 159, 190 N.E. 330 (1934) (surety had superior right to money due the contractor at the time of contractor's default); Fidelity & Deposit Co. v. City of Stafford, 93 Kan. 539, 144 P. 852 (1914) (surety who performed under performance bond is

issue becomes whether the surety can assert superior rights to the funds under equitable lien and subrogation doctrines[19] and thereby defeat the claims which the lender acquired by assignment. The courts traditionally have held in favor of the surety by entitling it to an equitable right of subrogation to the rights of the parties made whole by the surety's performance under the suretyship agreement.[20] The surety's rights under the equitable doctrines arise by operation of law to avoid injustice, and they exist independent of any expressed contractual terms.[21] In the 1896 decision of *Prairie State Bank v. United States*,[22] which involved a surety-lender conflict arising after the surety completed a government contract upon the contractor's default, the Supreme Court held that the surety possessed a superior equitable right to indemnification from the retained security funds held by the government. The Court declared that the surety was subrogated to the rights and remedies of the government, which was entitled to protect itself out of the withheld

entitled to retained funds under doctrine of equitable subrogation). The consensus appears to be that there is no difference in the result if the fund involves retainage or unearned progress payments. If, however, payments have already been paid to the lender, a different result may occur. *See* National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 847-48 (1st Cir. 1969).

19. *See* note 20 *infra*.

20. The basis of the equitable doctrines is that the surety's completion of the contract of payment of the outstanding claims entitles it to the disputed funds to the extent necessary for reimbursement and indemnification. The surety is therefore subrogated to the rights of those whom his performance benefits and relieves of obligations—the laborers and materialmen who have an equitable lien on funds to the extent of money due them and the owner who has a right to apply the retained funds to the cost of either completing the project, paying outstanding claims, or both. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132 (1962); Henningsen v. United States Fidel. & Guar. Co., 208 U.S. 404 (1908); National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969); National Sur. Corp. v. United States, 133 F. Supp. 381 (Ct. Cl. 1955) (where surety discharges its liability on contractor's bonds executed to United States by paying laborers and materialmen, its equities in money held by United States and due under contract are superior to those of bank who lent money to defaulting contractor). *See generally* Cushman, *The Surety's Right of Equitable Priority to Contract Balances in Relation to the Uniform Commercial Code*, 39 TEMP. L.Q. 239 (1966); Withers, *supra* note 12.

21. *See* Pearlman v. Reliance Ins. Co., 371 U.S. 132, 136-37 (1962); Jacobs v. Northeastern Corp., 416 Pa. 417, 426, 206 A.2d 49, 53 (1965); United States Fidel. & Guar. Co. v. Maryland Cas. Co., 186 Kan. 637, 643, 352 P.2d 70, 76 (1960) (surety's rights arise without regard to contract terms and are founded on principles of natural justice). Significantly, these equitable principles apply whether public or private construction contracts are involved. *See* Framingham Trust Co. v. Gould-National Batteries, Inc., 427 F.2d 856, 858 (1st Cir. 1970); Cramer, *Uniform Commercial Code: Surety v. Lender*, 3 THE FORUM 295 (1971); Withers, *supra* note 12. It is noteworthy that some commentators distingnish between express assignments to the surety and the surety's equitable rights. *See* Recent Development, 65 COLUM. L. REV. 927, 931 (1965); Note, *National Shawmut Bank: Another Step Toward Confusion in Surety Law*, 64 NW. U.L. REV. 582, 588-89 (1969).

22. 164 U.S. 227 (1896).

funds. Twelve years later, in *Henningsen v. United States Fidelity & Guaranty Co.*,[23] the Court adopted the reasoning of *Prairie State Bank* and upheld the surety's prior claim to contract balances due the defaulting contractor. After completing the construction project, the contractor failed to pay the laborers and materialmen who had an equitable lien on the retained funds. Performance by the surety under the payment bond prompted the Court to apply the equitable subrogation theory, granting the surety the rights of those laborers and materialmen whom he reimbursed. This trend of common-law decisions holding in favor of the surety culminated in *Pearlman v. Reliance Insurance Co.*[24] In that case the government had paid the balance due the bankrupt contractor to the trustee in bankruptcy while the surety had satisfied the claims of materialmen and laborers with an amount greater than the balance withheld. When the surety sought to recover the transferred funds, the Court declared that the surety owned an equitable lien or prior right to the fund before the bankruptcy adjudication.[25] Having lost these common-law contests for priority over the surety's interests, lenders advanced a new argument. Focusing on the enactment of the UCC, the lender contended that by perfecting the assignment to it of the contractor's rights, the lender gained priority over the surety under Article Nine of the Code.[26] Notably, no provision of the Code provides specifically for subrogation or for the surety's rights in construction contract litigation.[27] In assessing the effect of the Code on the surety's equitable subrogation rights, however, the courts and commentators generally have concluded that the common-law re-

23. 208 U.S. 404 (1908).

24. 371 U.S. 132 (1962). The Court stated that the equitable doctrines apply whether the bonds given by surety are for performance or payment, or both. Moreover, Justice Black avowed that "there are few doctrines hetter established than that a surety who pays the debt of another is entitled to all the rights of the person he paid to enforce his right to be reimbursed." *Id.* at 136-37.

25. The reasoning of the *Pearlman* Court was that: "[T]he Government had a right to use the retained fund to pay laborers and materialmen; . . . the laborers and materialmen had a right to he paid out of the fund; . . . the contractor, had he completed his job . . . would have become entitled to the fund; [and therefore,] the surety, having paid the laborers and materialmen, is entitled to the henefit of all those rights to the extent necessary to reimburse it." *Id.* at 141; *see* Cushman, *supra* note 20, at 244.

26. Since the lender's security interest is provided for by the Code and since the lender has perfected its interest by filing in compliance with the relevant Code provisions, the lender claims priority over what it argues is the surety's unperfected security interest in the same collateral. For the provisions under which the lender claims priority, *see* UNIFORM COMMERCIAL CODE §§ 9-301(1), 9-312(5).

27. *See* National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 846-47 (1st Cir. 1969); Note, *supra* note 12.

sult favoring the surety remains unaltered.[28] For instance, in the leading case of *National Shawmut Bank v. New Amsterdam Casualty Co.*,[29] the Court of Appeals for the First Circuit recognized that section 1-103[30] of the Code explicitly preserves all principles of law and equity unless displaced by specific Code provisions.[31] Extending this rationale, the *National Shawmut Bank* court set forth the generally accepted proposition that the Code cannot displace the common-law results since the surety's equitable claims are not security interests within the Code.[32] Article Nine applies only to consensual security interests created by contract,[33] whereas the surety's equitable rights, inherent in the suretyship relation, arise by operation of law and not from consent of the parties.[34] Rejecting the lender's argument, the courts have concluded that a surety does not need to file and perfect under the UCC to protect its equitable

28. *See* Mickelson v. Aetna Cas. & Sur. Co., 452 F.2d 1219 (8th Cir. 1971) and cases cited therein; National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843 (1st Cir. 1969); Jacobs v. Northeastern Corp., 416 Pa. 417, 206 A.2d 49 (1965); UNIFORM COMMERCIAL CODE § 9-102, Comment 1; J. WHITE & R. SUMMERS, UNIFORM COMMERCIAL CODE 769-70 (1972). *But see* United States v. G.P. Fleetwood & Co., 165 F. Supp. 723, 725 (W.D. Pa. 1958) (where performance bond application was not filed under UCC, surety had no right as lienholder against principal's bankruptcy trustee); Hartford Accident & Indem. Co. v. State Pub. School Bldg. Authority, 26 Pa. D. & C.2d 717, 726-33 (1961) (surety required to file and perfect under UCC its performance bond application in order to protect its rights against lending bank); Recent Development, *supra* note 21; Note, *supra* note 21.

29. 411 F.2d 843 (1st Cir. 1969).

30. UNIFORM COMMERCIAL CODE § 1-103. This section provides: "Unless displaced by the particular provisions of this Act, the principles of law and equity . . . shall supplement its provisions."

31. 411 F.2d at 845; *see* Cushman, *supra* note 20, at 248.

32. 411 F.2d at 845. The surety's argument is that the definitional sections of the UCC pertaining to security interests—§§ 1-201(37) and 9-102(1)(a) and (b)—are not applicable to its interest. The surety asserts that its interest in the construction contract is neither an interest in personal property or contract rights to secure an obligation, nor a purchase of contract rights. The securing of payment to the surety actually results from "the opportunity, on default, to finish the job and apply any available funds against its cost of completion." *Id.* The *Shawmut* court further states that "[w]hile one may strain to say that the right to finish a job in an emergency and thus minimize damages is a contract right, we think it is not the kind of independently valuable asset that such synonyms as 'goods, documents, instruments, general intangibles, [and] chattel paper' suggest." *Id.* at 846.

33. "Rights of subrogation, although growing out of a contractual setting and ofttimes articulated by the contract, do not depend for their existence on a grant in the contract, but are created by law to avoid injustice. Therefore, subrogation rights are not 'security interests' within the meaning of Article 9. The sureties' rights . . . are not the usual type of consensual security interests contemplated by the Code. Jacobs v. Northeastern Corp., 416 Pa. 417, 429, 206 A.2d 49, 55 (1965); *see* J. WHITE & R. SUMMERS, *supra* note 28, at 757-58.

34. *See* Mickelson v. Aetna Cas. & Sur. Co., 452 F.2d 1219, 1222 (8th Cir. 1971); Framingham Trust Co. v. Gould-National Batteries, Inc., 427 F.2d 856 (1st Cir. 1970); National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 846 (1st Cir. 1969) (rights of surety not created by contract but rather by a status resulting from the contract).

claims against the lender's perfected security interest in the contractor's contract rights.[35] Moreover, some courts and commentators, focusing on collateral sections of the UCC,[36] have asserted that certain Code provisions specifically exclude the surety's rights from Article Nine.[37] Further analysis of the Code's effect on the surety-lender conflict has involved investigation of the legislative history of the UCC. The 1952 Official Draft included a proposed provision, section 9-312(7),[38] which clearly subordinated the surety's rights to retained funds, whether or not perfected, to the perfected security interest of a subsequent lender.[39] In response to vigorous reaction and criticism by surety representatives, however, the Editorial Board of the UCC chose to eliminate section 9-312(7) from subsequent Code drafts.[40] The majority of courts and commentators have cited the deletion of section 9-312(7) as authority for the conclusion that the Code was not intended to overrule the established case law and consequently does not restrict the surety's traditional rights to

35. *See* cases and materials cited notes 20, 28 & 32 *supra*.

36. The *National Shawmut Bank* court discusses, among others, section 9-106, which defines "account" and "contract right." Addressing the possibility that this section covers a surety's rights, the court answered negatively. As to "account," the court said that there is no right to payment when a contractor defaults. As to "contract right," the court found such a right more akin to a right to receive payments from one who continues with performance than to a right conditioned on performance by the transferee of the right. 411 F.2d at 846.

37. For discussions of §§ 9-104(c), (f), and (i), see Cramer, *supra* note 21, at 307-09; Withers, *supra* note 12, at 370-71; Note, *supra* note 12, at 586; J. WHITE & R. SUMMERS, *supra* note 28, at 777-78. For arguments of those who advocate application of the Code to the surety's rights, see Recent Development, *supra* note 21 at 931-33; Note, *supra* note 21, at 292-94; Note, *Jacobs v. Northeastern Corp.: Surety's Dilemma—Subrogation Rights or Perfected Security Interest*, 69 DICK. L. REV. 172 (1965).

38. Section 9-312(7) provided: "A security interest which secures an obligation to reimburse a surety or other person secondarily obligated to complete performance is subordinate to a later security interest given to a secured party who makes a new advance, incurs a new obligation, releases a perfected security interest or gives other new value to enable the debtor to perform the obligation for which the earlier secured party is liable." *See* UNIFORM COMMERCIAL CODE § 9-312(7) (1952 version), as cited in Withers, *supra* note 12 at 364.

39. *See* UNIFORM COMMERCIAL CODE § 9-312(7), Comment 9 (1952 version), as cited in Withers, *supra* note 12 at 364. Referring to the type of construction contract situation discussed in this comment, the Code's editors stated that subsection (7) subordinated a surety's interest to a later security interest taken for new value to enable a debtor (contractor) to perform the contract for which the surety is contingently liable.

40. The Board observed that "[u]nder the existing case law, the surety's rights come first as to the funds . . . unless the surety has subordinated its rights to the (lender). Subsection (7) . . . as written would reverse the situation and give the (lender) priority in all cases. It was the feeling of the Editorial Board that existing law should not be disturbed. . . . Subsection (7) . . . was not an oversight. . . . However, the Editorial Board feels that its inclusion was a mistake." *See* UNIFORM COMMERCIAL CODE § 9-312 (1953 version), as cited in Withers, *supra* note 12 at 365.

the disputed funds.[41] The weight of authority, therefore, compels the conclusion that the surety who performs his bond obligations upon default of a contractor is subrogated to the rights of the contractor as to outstanding receivables due the contractor, the laborers and materialmen whom the surety has paid, and the owner for whom the surety has completed the project.[42] No decision, however, has considered the issue whether the surety's superior equitable rights in retained proceeds extend further to a defaulting contractor's personal property that has served as additional collateral on a secured construction loan.

The instant court recognized at the outset the clearly established equitable lien and subrogation theories that are applicable to the surety-lender contest for retained contract proceeds.[43] The court next distinguished the instant factual situation from previous surety-lender disputes by emphasizing that it involved conflicting claims to proceeds from the sale of a defaulting contractor's personal property, and not to retained funds due the contractor. The court then reasoned that since the facts reveal no unjust enrichment of, or unconscionable property retention by, the lender,[44] the instant case does not give rise to the application of equitable doctrines. The court declared that the surety possessed not an equitable lien on the sale proceeds but a security interest under the Code[45] subject to the Article Nine filing and perfection requirements.[46] The court further determined that the contractor's performance bond application did not convey to the surety a contract right as defined by the Code.[47] Reasoning that the surety received an interest in personal property as security to guarantee reimbursement if required to perform under

41. *See* cases and articles cited notes 12, 20, & 28 *supra*. *But see* articles cited note 21 *supra*.

42. *See* National Shawmut Bank v. New Amsterdam Cas. Co., 411 F.2d 843, 845 (1st Cir. 1969).

43. The court acknowledged that these theories control when there is an assignment to the lender by the contractor.

44. The court cited these 2 factors as being among those which form the foundation of equity jurisprudence. The court buttresses its reasoning by stating that neither the surety nor the lender can he fully reimbursed by the sale proceeds. The court also noted that while the equitable lien theory has survived the enactment of the UCC, recent decisions indicate that the doctrine of equitable mortgages is no longer necessary in commercial transactions, mainly because Article 9 reduces formal requisites to a minimum. *See* Shelton v. Erwin, 472 F.2d 1118, 1120 (8th Cir. 1973).

45. *See* UNIFORM COMMERCIAL CODE § 1-201(37).

46. *See* UNIFORM COMMERCIAL CODE §§ 9-301(1), -312. As to questions of priority of interests, the surety is in the position of a general unsecured creditor; the surety has an unperfected security interest since it has not filed.

47. *See* UNIFORM COMMERCIAL CODE § 9-106.

the suretyship obligations,[48] the court concluded that section 9-104(f),[49] which excludes certain transfers from Article Nine, did not exclude the surety's security interest from Article Nine filing requirements.[50] Refusing to extend the established equitable doctrines to collateral interests in personal property, the court held that since the lender perfected first under the Code, the lender's security interest in the contractor's equipment prevailed over the unperfected interest of the surety in the same property.

The rejection by the instant court of the surety's attempt to extend equity doctrines from retained-fund disputes[51] to personal property conflicts has a sound basis. Significant distinctions exist between equitable claims to funds withheld by the owner and assigned rights in a debtor-contractor's equipment; the surety's proposed analogy between the two cannot be justified. An analysis of the decisions involving competing claims to retained proceeds reveals that such funds serve the primary purpose of securing complete contract performance. It appears that the owner withholds funds to provide an incentive for the participating parties to complete properly the construction project. Existing in order to encourage and insure cooperative performance by all construction contract participants, these funds assume, therefore, a substantial role in the relationship of the contractor, surety, and lender. In contrast, no such central purpose characterizes the assignment to the surety of an interest in the contractor's equipment. The assignment, while admittedly bearing some relationship to the ultimate goal of complete contract performance, becomes a less significant influence on contract completion when viewed in light of the rationale underlying the existence of retained funds. Essentially, the assignment constitutes a virtually isolated transaction between the surety and the contractor whereby the surety, desiring some personal security for the performance it supplies, obtains an assignment of personal property from the contractor;[52] this transaction has no direct relation to contract performance by the surety for the owner. Moreover, an analysis of both the status and resulting rights of the participating parties further distinguishes the instant case from those involv-

48. The court stated that this interest is precisely the kind that the UCC was intended to govern.

49. Section 9-104(f) provides: "This Article does not apply to . . . a transfer of a contract right to an assignee who is also to do the performance under the contract."

50. Evidently, the surety did not advance any other exclusion arguments.

51. *See* notes 15-18 *supra* and accompanying text.

52. The surety ostensibly is informing the contractor that it wants some security from the contractor itself—that runs hetween the two alone—as protection in case of default.

ing retained proceeds. By its suretyship performance the surety generally acquires only those rights possessed by the creditors whose claims or obligations it satisfies.[53] The creditors through whom the surety claims superior rights in funds and contract proceeds —primarily the owner and laborers and materialmen—possess themselves a prior right to such funds as against other general creditors. Either the express contract provisions creating the funds or doctrines providing equitable rights to them may establish such prior claims.[54] When, therefore, the surety performs its suretyship obligations upon default of the contractor, it receives rights superior to those of other general creditors.[55] In the instant case, however, the creditors whose rights the surety obtained by performance had no prior claim to the contractor's equipment; they held no preferred status as to other general creditors. Unlike the retained funds, the equipment of the contractor does not represent an interest set aside to secure complete performance and payment. Moreover, since the respective assignments of personal property by the contractor to the lender and surety constitute essentially separate transactions, the owners as well as the laborers and materialmen have no bona fide equitable or expressed rights in the equipment. Upon default of the contractor, the most that the surety can claim through these creditors is the status of a general creditor with no prior rights in the equipment. To provide the surety inherent equitable rights in the contractor's personal property would therefore necessitate a distorted extension of the rationale favoring the surety in retained-fund disputes. Turning to a consideration of whether the UCC should apply to the instant factual situation in light of the noted distinctions, an affirmative answer is compelled. It must be emphasized that the conflict in the instant case involved personal property interests covered specifically by the Code, and not claims to retained funds. The surety ostensibly acquired an assignment from the contractor in order to obtain individual security in equipment, and therefore possessed a direct interest in personal property. It seems clear that the surety and the contractor intended by their transac-

53. *See generally* L. SIMPSON, HANDBOOK ON THE LAW OF SURETYSHIP (1950) [hereinafter cited as SIMPSON].

54. In light of the overall purpose of the funds, such priorities are not unrealistic. Moreover, as noted previously, it is well established that laborers and materialmen possess prior equitable liens on such proceeds. *See* note 20, *supra*.

55. The surety generally receives these rights through the doctrine of equitable subrogation. The equitable claims to the equipment asserted by the surety in the instant case seem to evolve from this doctrine rather than by reason of the assignment. *See* SIMPSON, *supra* note 53, at § 47.

tion, just as did the lender and contractor, to create a consensual security interest as defined by the Code.[56] These transactions resemble the frequently utilized commercial financing arrangements that involve personal property as collateral. The UCC, and particularly Article Nine, was promulgated with the specific purpose of governing commercial transactions of this kind.[57] Refusal to apply the Code to the surety's personal property interest in the instant case would, therefore, not only impede the effectiveness of particular provisions of the Code but also significantly hinder the important goal of achieving legal uniformity in the complex field of commercial financing. Furthermore, if a secured lender has no assurance that it can rely on the Code to protect its security interests, the lender may exercise excessive caution in making loans to contractors, especially those engaged in smaller business operations. Consequently, many contractors who genuinely need such loans will be denied the opportunity to obtain them. With less competition among contractors inevitably resulting from such restrained attitudes, the public interest as well as the construction industry would be harmed.[58] Admittedly, the lender presumably knows that a surety has guaranteed a given construction contract, and moreover, is most likely aware of the surety's rights to retained funds and contract proceeds. For notice of the surety's interests in the contractor's personal property, however, the lender relies almost exclusively on the Code. Having complied with the Code requisites for protecting its interests, the lender expects other creditors with similar interests to do likewise. The desired result is that all parties involved in the construction contract will have the opportunity to learn of conflicting interests in the same property. To facilitate this result the Code has reduced the formal requisites for protecting security interests to a minimum. An investigation of the simplified, inexpensive filing and perfection requirements indicates that the surety can easily avail itself of adequate legal protection for its personal property interests. Filing by the surety in the instant case would have given it a prior claim to the contractor's equipment.[59] The instant court, therefore, has es-

56. *See* UNIFORM COMMERCIAL CODE §§ 1-201(37), 9-102.

57. *See* UNIFORM COMMERCIAL CODE § 9-102, Comment 1.

58. For an argument stating that similar dilemmas would result if the Code were applied to disputes over retained funds, see Cushman, *supra* note 20, at 249-55.

59. Since most surety-lender conflicts in construction contract arrangements seem to involve loans made subsequent to the execution of the suretyship agreement, immediate filing and perfection by the surety of its personal property interests would insure the surety's priority in the majority of situations. For an interesting argument proposing that the surety has a purchase money security interest in the retained funds, see Recent Development, *supra* note 21.

tablished a significant new precedent to govern the continuing conflict between equitable doctrines favoring the surety and application of the UCC, and has determined, correctly it seems, that the surety, like other general creditors, must readily comply with the relevant Code provisions to protect its personal property interests in certain commercial transactions.