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Recent Cases

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RECENT CASES

Antitrust Law—Robinson-Patman Act—To Satisfy the "In Commerce" Requirement of Section 2(a) at Least One of the Allegedly Discriminatory Sales in a Secondary-Line Case Must Cross a State Line

Plaintiff paving and asphalt company brought suit for damages[1] in federal district court, alleging that defendant supplier[2] of crushed limestone had violated section 2(a) of the Robinson-Patman Price Discrimination Act[3] by charging plaintiff higher prices for stone than it charged other customers.[4] Defendant challenged the court's subject matter jurisdiction,[5] arguing that since all

1. Plaintiff sought damages for allegedly discriminatory sales by defendant over a 10-year period, 1958-1968. The district court ruled that only the period within the 4-year statute of limitations—since August 29, 1965—was actionable. The instant court did not reach this question because of its holding for defendant.

2. The supplier was originally known as Material Service Corporation. On December 31, 1959, General Dynamics acquired the assets of the supplier through a statutory merger, after which the supplier operated as Material Service Division. In March 1969, it was incorporated as a wholly-owned subsidiary. Plaintiff's original complaint named only General Dynamics Corporation as defendant. In its answer, General Dynamics counterclaimed on behalf of Material Service Corporation for foreclosure of a mortgage and for balances due on a promissory note and open account. Plaintiff replied to the counterclaim, then moved for summary judgment or dismissal of the counterclaim on the ground that Material Service Corporation was not a party to the action. The result of this procedural dispute, a collateral issue in the instant case, was that Material Service Corporation was held a proper party to the suit either as a joined defendant or as a third-party defendant. Mayer Paving & Asphalt Co. v. General Dynamics Corp., 486 F.2d 763, 772 (7th Cir. 1973).

3. Robinson-Patman Price Discrimination Act § 2(a), 15 U.S.C. § 13(a) (1970), provides in part:

> It shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly, to discriminate in price between different purchasers or commodities of like grade and quality, where either or any of the purchases involved in such discrimination are in commerce, where such commodities are sold for use, consumption, or resale within the United States or any Territory thereof or the District of Columbia or any insular possession or other place under the jurisdiction of the United States, and where the effect of such discrimination may be substantially to lessen competition or tend to create a monopoly in any line of commerce, or to injure, destroy, or prevent competition with any person who either grants or knowingly receives the benefit of such discrimination, or with customers of either of them . . . .

4. Defendant made sales of crushed limestone to both Indiana and Illinois purchasers. Plaintiff, an Illinois customer, was charged from 20-30¢ more per ton than its Illinois competitor.

5. The Robinson-Patman Price Discrimination Act requires the presence of each of

of the allegedly discriminatory sales by defendant to plaintiff and its actual competitors were strictly intrastate,[6] plaintiff had failed to satisfy the Act's requirement that "either or any of the purchases involved in such discrimination [must be] *in commerce* . . . ." (emphasis added).[7] Plaintiff contended that defendant's sales at more favorable prices to out-of-state customers, whether actual competitors of plaintiff or not, were sufficient to establish the "in commerce" jurisdictional prerequisite for a Robinson-Patman Act suit. Accepting defendant's argument, the district court granted judgment *n.o.v.*[8] On appeal to the United States Court of Appeals

these jurisdictional elements: "a discrimination must arise from (A) consummated contemporaneous sales transactions (B) by the same seller to different purchasers, which (C) involve 'commodities' of (D) 'like grade and quality,' and (E) occur 'in commerce'." F. ROWE, PRICE DISCRIMINATION UNDER THE ROBINSON-PATMAN ACT 45 (1962) [hereinafter cited as ROWE, PRICE DISCRIMINATION]. The dispute in this case focuses primarily on the "in commerce" requirement. The district court held that requirements (A) through (D) had been satisfied. Because the Seventh Circuit held that the "in commerce" requirement had not been met in the instant case, it had no occasion to affirm or reject the district court's conclusion regarding the other jurisdictional elements.

6. The court noted that plaintiff had alleged neither potential nor actual competition with defendant's purchasers in Indiana. 486 F.2d at 767 n.2a. Thus, plaintiff's only competition involving discriminatory prices occurred with other customers of defendant located wholly within Illinois. Defendant argued, therefore, that any interstate sales it made to Indiana customers at prices lower than those charged to plaintiff were not related to the alleged intrastate discrimination against plaintiff and thus could not be regarded as "in commerce" for the purpose of invoking jurisdiction under § 2(a) of the Robinson-Patman Act.

7. Robinson-Patman Price Discrimination Act § 2(a), 15 U.S.C. § 13(a) (1970). "Commerce" is defined generally in the Clayton Act as interstate commerce: "trade or commerce among the several States and witb foreign nations, or between the District of Columbia or any Territory of the United States and any State, Territory, or foreign nation . . . ." 15 U.S.C. § 12 (1970). The interstate commerce requirement under different sections of the Robinson-Patman Act, however, is not stated uniformly. Sections 2(c), 2(d), 2(e), 2(f) and 3 apply to discriminatory practices by persons "engaged in commerce" in the "course of such commerce." Section 2(a) requires additionally that "either or any of the purchases" be "in commerce." Robinson-Patman Price Discrimination Act, §§ 2(a)-(f), 15 U.S.C. §§ 13(a)-(f) (1970). *See generally* Kintner & Mayne, *Interstate Commerce Requirement of the Robinson-Patman Price Discrimination Act*, 58 GEO. L.J. 1117, 1117-18 & nn.4-7 (1970) [hereinafter cited as Kintner & Mayne]; Rowe, *Discriminatory Sales of Commodities in Commerce: Jurisdictional Criteria Under the Robinson-Patman Act*, 67 YALE L.J. 1155, 1166 n.43 (1958) [hereinafter cited as Rowe, *Discriminatory Sales*]. Defendant suggested in its brief that its sales to Indiana customers, transacted primarily at defendant's quarry in Illinois, probably were not "in commerce" under section 2(a), but proceeded arguendo as if they were. In a footnote to the opinion, the court stated tbat these "were clearly intrastate sales." 486 F.2d at 767 n.2a. The dissent argued that the existence of defendant's sales office in LaPorte, Indiana, and distribution yard in Gary, Indiana, controverted this dictum by the majority. *Id.* at 773. Despite its dictum, the court based its holding on the assumption that the sales to Indiana purcbasers were in interstate commerce.

8. In the district court, the jury had found that defendant's sales had caused plaintiff competitive injury and had awarded plaintiff $498,204 in damages.

for the Seventh Circuit, *held*, affirmed. To satisfy the section 2(a) "in commerce" jurisdictional requirement of the Robinson-Patman Price Discrimination Act, a purchaser must establish that one of the allegedly discriminatory sales to himself or his actual competitor crossed a state line. *Mayer Paving & Asphalt Co. v. General Dynamics Corp.*, 486 F.2d 763 (7th Cir. 1973), *review denied*, 42 U.S.L.W. 3401 (U.S. Jan. 15, 1974).

Section 2 of the original Clayton Act of 1914[9] provided for regulating unfair price discrimination[10] and was aimed particularly at national trusts' practices that involved discrimination which adversely affected sellers with whom the trusts were competing.[11] This type of discrimination, primary-line, is contrasted with secondary-line discrimination[12] that occurs where defendant sells like commodities at different prices to different customers, thus unfairly favoring one customer over the other. Even though the Supreme Court subsequently extended the reach of section 2 to secondary-line discriminatory pricing practices,[13] the evolution of mass distribution methods,[14] which threatened the conventional manufacturer-

9. Clayton Act § 2, ch.323, § 2, 38 Stat. 730 (1914), *as amended* 15 U.S.C. § 13(a) (1970), provides in pertinent part:

> That it shall be unlawful for any person engaged in commerce, in the course of such commerce, either directly or indirectly to discriminate in price between different purchasers of commodities, which commodities are sold for use, consumption, or resale within the United States . . . where the effect of such discrimination may be to substantially lessen competition or tend to create a monopoly in any line of commerce: *Provided*, That nothing herein contained shall prevent discrimination in price between purchasers of commodities on account of differences in the grade, quality, or quantity of the commodity sold, or that makes only due allowance for difference in the cost of selling or transportation, or discrimination in price in the same or different communities made in good faith to meet competition . . . .

10. The term "discrimination" connotes different meanings in economic, legal, and colloquial contexts. In economic parlance it carries a neutral connotation and may evidence healthy, desirable competition; indeed the process of competition presupposes transitory price discriminations. *See* ROWE, PRICE DISCRIMINATION, *supra* note 5, at 25-31. Legal price discrimination, on the other hand, occurs where there is a substantial price difference. FTC v. Anheuser-Busch, Inc., 363 U.S. 536, 549 (1960). *See generally* ROWE, PRICE DISCRIMINATION, *supra* note 5, at 25-35.

11. These national trusts would lower prices in selected areas, often below cost, with the purpose of eliminating smaller, local competing sellers. *See* Rowe, *The Evolution of the Robinson-Patman Act: A Twenty-Year Perspective*, 57 COLUM. L. REV. 1059, 1063-64 (1957) [hereinafter cited as Rowe, *Evolution*].

12. The distinction between primary- and secondary-line discrimination is noted in FTC v. Anheuser-Busch, Inc., 363 U.S. 536 (1960). Commentators have added third-line discrimination, suffered by a disfavored customer in his competition with customers of the defendant supplier's favored purchaser, and fourth-line discrimination, suffered by a disfavored customer in his competition with a customer of a customer of defendant supplier's favored purchaser. *See generally* E. KINTNER, A ROBINSON-PATMAN PRIMER 92-99 (1970).

13. George Van Camp & Sons Co. v. American Can Co., 278 U.S. 245 (1929).

14. Mass distrihutors, particularly chain stores, and mail order merchandisers inte-

wholesaler-retailer distribution arrangement, revealed additional inadequacies of section 2.[15] The Robinson-Patman Act[16] was enacted in 1936 as an amendment to section 2 of the Clayton Act to correct these weaknesses and to strengthen existing legislation.[17] The original section 2 had prohibited discrimination by "any person engaged in commerce, in the course of such commerce . . . ."[18] This left unanswered the question whether a seller was prohibited from discriminating against a purchaser located in the same state if the seller was also engaged in interstate business.[19] The congressional answer, section 2(a) of theRobinson-Patman Act, added the troublesome phrase "where either or any of the purchases involved in such discrimination are in commerce . . . ."[20] Legislative history indicates that, in adding this phrase, Congress intended to prohibit price discrimination occurring intrastate as well as interstate, "wherever it is of such a character as tends directly to burden or affect interstate commerce."[21] Several commentators, however, have asserted that the deletion of the clause "whether in commerce or not" from the House version of the bill refutes such a broad interpretation of the phrase.[22] Further supporting a narrow reading

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grated the retailing and wholesaling functions, permitting them to deal directly with suppliers and thus to eliminate middleman costs. In addition, mass distributors were able, through their centralized purchasing departments, to obtain significant discounts by purchasing large quantities of supplies in bulk from suppliers. The result was that mass distributors received goods from suppliers at substantially lower prices than conventional retailers could. Rowe, *Evolution, supra* note 12, at 1061-63.

15. Three principal weaknesses of § 2 were: (1) the provision permitting quantity discounts; (2) the provision permitting price discriminations between purchasers made in good faith to meet competition; and (3) the provision prohibiting price discriminations only by one "engaged in commerce, in the course of such commerce." *See* H.R. REP. No. 2287, 74th Cong., 2d Sess. 7 (1936) [hereinafter cited as H.R. REP. No. 2287]. For the text of § 2 of the Clayton Act of 1914 see note 9 *supra*.

16. 15 U.S.C. §§ 13(a), 13(b), 21(a) (1970). *See* note 3 *supra* for the text of § 2(a).

17. H.R. REP. No. 2287, *supra* note 15, at 7.

18. Clayton Act, ch. 323, § 2, 38 Stat. 730 (1914), *as amended* 15 U.S.C. § 13(a) (1970).

19. *See* Note, *The Commerce Requirement of the Robinson-Patman Act*, 22 HASTINGS L.J. 1245, 1246 (1971).

20. 15 U.S.C. § 13(a) (1970). The original "in commerce" language of § 2 was not deleted. Thus the present "in commerce" test contains 3 requirements, of which only the third is deemed important: (1) the discriminator must he "engaged in commerce"; (2) the challenged discrimination must occur "in the course of such commerce"; and (3) "either or any of the purchases involved [must be] in commerce." If the third condition is met, the first two are necessarily fulfilled. *See* Rowe, *Discriminatory Sales, supra* note 7, at 1166-67.

21. H.R. REP. No. 2287, *supra* note 15, at 8.

22. *See, e.g.*, Rowe, *Discriminatory Sales, supra* note 7, at 1166 n.46, *citing* H.R. REP. No. 2591, 74th Cong., 1st Sess. 6 (1936). In the same conference report, however, the Committee indicates why it had agreed to delete the clause, stating "[t]his was omitted, as the preceding language [referring to the present language of section 2(a)] already covers *all* discriminations, both interstate and intrastate, that lie within the *limits of Federal*

of the Robinson-Patman Act generally, and the Act's "in commerce" requirement particularly, is a recognition of the latent conflict between vigorous regulation of price discrimination and the basic antitrust policy of encouraging competition. Competition feeds on transitory price discrimination, and to the extent that enforcement of the Robinson-Patman Act imposes uniformity of prices, it necessarily stifles competition.[23] Recognizing this conflict,[24] the Supreme Court imposed a duty on the courts and the Federal Trade Commission to reconcile Robinson-Patman Act interpretations with the broader policies of the antitrust laws.[25] Courts that have adjudicated the reach of the interstate commerce provision of section 2(a) in cases involving intrastate discrimination by a seller also engaged in interstate activity have not been notably influenced by the opposition of these above mentioned forces.[26]

In the leading case interpreting the scope of the "in commerce" jurisdictional requirement of section 2(a), *Moore v. Mead's Fine Bread Co.*,[27] the Supreme Court did, however, rely on the legislative history of the Robinson-Patman Act. In that case the Court held that section 2(a) prohibited strictly intrastate price discrimination when defendant seller utilized profits derived from interstate sales to subsidize local, discriminatory price cuts, even though plaintiff seller had not competed with defendant for the out-of-state customers.[28] Subsequent primary-line decisions by federal courts of ap-

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authority." *Id.* at 6 (emphasis added). Another writer contends that Congress deleted the clause because of its belief that the language was unconstitutional in light of the Supreme Court's decision in Schecter Poultry Corp. v. United States, 295 U.S. 495 (1935), which was handed down only 2 weeks before Representative Patman introduced the original bill. *See* Note, *supra* note 19, at 1256.

23. *See* note 10 *supra*. *See generally* ROWE, PRICE DISCRIMINATION, *supra* note 5, at 24-35.

24. The Supreme Court has acknowledged this potential clash between the Robinson-Patman Act and general antitrust policy, first in Standard Oil Co. v. FTC, 340 U.S. 231, 248-49 (1951), and again in Automatic Canteen Co. v. FTC, 346 U.S. 61, 63 (1953).

25. Automatic Canteen Co. v. FTC, 346 U.S. 61, 74 (1953). A corollary to this duty of reconciling Robinson-Patman interpretations with antitrust policy is that section 2(a) of the Robinson-Patman Act is intended to protect competition, not individual competitors. Presumbably, if competition is protected, the process will sustain efficient competitors and weed out the inefficient, ultimately serving the best interest of the consuming public. *See generally* ROWE, PRICE DISCRIMINATION, *supra* note 5, at 126-32.

26. *See* ROWE, PRICE DISCRIMINATION, *supra* note 5, at 131. *See also* note 25 *supra*.

27. 348 U.S. 115 (1954).

28. Plaintiff in *Moore* operated an intrastate bakery in New Mexico. Defendant, a corporation in New Mexico, unfairly undercut prices in New Mexico, but also made sales to customers in Texas. Furthermore, defendant was one of several corporations, some of which were located in Texas, that used the same name and a common advertising program and that were linked by interlocking ownership and management. The Court noted that defendant subsidized local pricecuts in New Mexico with profits both from its own sales across the state

peals, rarely mentioning the legislative history or general antitrust policy, have noted that one of defendant's discriminatory sales in *Moore* in fact crossed a state line. The decisions accordingly have treated *Moore's* expansive interpretation of the interstate commerce provision largely as dictum and have required that at least one of the challenged discriminatory sales cross a state line. In *Food Basket, Inc. v. Albertson's, Inc.*,[29] the Tenth Circuit refused jurisdiction under section 2(a) because none of the allegedly discriminatory sales crossed a state line, despite plaintiff's argument that defendant used interstate profits to underwrite the local price cuts. The court held that the use of profits derived from sales transactions conducted solely in another state by another store in defendant corporation's chain constituted an insufficient interstate nexus with the challenged intrastate price discrimination. In a recent decision on rehearing *en banc*, the Fifth Circuit reversed its earlier decision in *Littlejohn v. Shell Oil Co.*[30] on grounds similar to those in *Food Basket*. In *Littlejohn*, plaintiff alleged only that defendant underwrote intrastate discrimination with interstate profits. The majority held that in order to satisfy the section 2(a) jurisdictional requirement plaintiff must also demonstrate that at least one discriminatory transaction crossed a state line. Another restrictive dimension to the "in commerce" requirement was added by the Sixth Circuit in *Willard Dairy Corp. v. National Dairy Products Corp.*[31] In that case, the court held that since defendant plant, an independent subsidiary of an interstate corporation, made its own sales only in Ohio, the "in commerce" requirement had not been met, even though a related Ohio subsidiary plant of the corporation sold like commodities in interstate commerce. Justice Black, dissenting in the Supreme Court's denial of certiorari in the case, argued that even though the local plant sold strictly intrastate, it, like the other subsidiaries, drew on the economic power of the national operation—a factor that he contended should be sufficient to bring the local price discrimination within the purview of section 2(a).[32] The

lines to Texas customers and from sales by its related corporations in other states. In support of its decision, the Court referred to a statement by Congressman Utterback, manager of the Robinson-Patman bill in the House, that interstate commerce may not be used by a seller to burden local trade any more than local commerce may be used to injure interstate trade. 348 U.S. at 116-20.

29. 383 F.2d 785 (10th Cir. 1967).

30. 483 F.2d 1140 (5th Cir.) (*en banc*), *cert. denied*, 94 S. Ct. 849 (1973), *rev'g* 456 F.2d 225 (5th Cir. 1972). For comments on the earlier case see 26 VAND. L. REV. 146 (1973) and 86 HARV. L. REV. 765 (1973).

31. 309 F.2d 943 (6th Cir. 1962).

32. 373 U.S. 934, 935-36 (1963) (Black, J., dissenting), *denying cert. to* 309 F.2d 943 (6th

Sixth Circuit reaffirmed its *Willard* decision when faced with very similar facts in *Cream Crest-Blanding Dairies v. National Dairy Products Corp.*[33] In its petition for Supreme Court review, the *Cream Crest* plaintiff argued that the Sixth Circuit in *Willard* had misread *Moore* as turning on an interstate sale for its conclusion that defendant was in commerce, rather than on the interlocking ownership and management of affiliated corporations.[34] The Supreme Court again denied certiorari.[35] In *Borden Co. v. FTC,*[36] one of the few secondary-line cases addressing the scope of the interstate commerce jurisdictional requirement under section 2(a), plaintiff purchaser alleged that defendant seller, the local subsidiary of an interstate corporation, was favoring other intrastate purchasers with lower prices. Reversing the trial examiner, the FTC granted jurisdiction.[37] The Commission, in a transparent attempt to expand the scope of section 2(a), reasoned that since Borden was an interstate company all of its products must be in commerce, and therefore concluded that the interstate commerce requirement was satisfied. The Seventh Circuit reversed,[38] citing *Willard* and noting that the challenged local plant produced, processed, and sold its products wholly within the state. Despite the seemingly favorable legislative history, until recently only the flow of commerce doctrine[39]—inapplicable to the factual situation of the instant case—has made any advance against this citadel of restrictive readings of the "in commerce" provision of section 2(a).

In the instant case, the Seventh Circuit characterized the juris-

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Cir. 1962).

33. 370 F.2d 332 (6th Cir.), *cert. denied,* 387 U.S. 930 (1967). The only notable factual difference from *Willard* was that defendant plant in *Cream Crest-Blanding* was ultimately controlled by corporate officers outside the state.

34. *See* Kintner & Mayne, *supra* note 7, at 1122 & n.30.

35. 387 U.S. 930 (1967).

36. 339 F.2d 953 (7th Cir. 1964).

37. Borden Co. v. FTC, [1963-1965 Transfer Binder] TRADE REG. REP. ¶ 16,776, at 21,717 (FTC 1964).

38. 339 F.2d 953 (7th Cir. 1964).

39. The flow of commerce doctrine developed during a period of judicial expansion of the reach of the Sherman Act. Under this doctrine, the commerce power of the Constitution may reach parties who come into contact with goods that are moving in interstate commerce. The point at which such goods "come to rest" is the extremity beyond which the commerce power cannot reach. Substantial alteration of the goods and temporary storage of the goods for too great a period of time are 2 of the situations in which courts have found that the goods have lost their interstate character. The doctrine was first found applicable under the Robinson-Patman Act in Standard Oil Co. v. FTC, 340 U.S. 231 (1951). The Court distinguished the facts of the instant case from those in flow of commerce cases under § 2(a). 486 F.2d at 769. For a discussion of the applicability of the doctrine under section 2(a) see Note, *supra* note 19, at 1262-66. *See also* Kintner & Mayne, *supra* note 7, at 1130-33.

dictional issue under section 2(a) of the Robinson-Patman Price Discrimination Act as a question of statutory interpretation and declined to examine the constitutional reach of the statute.[40] The court looked initially to *Moore v. Mead's Fine Bread Co.*[41] and *Borden Co. v. FTC*[42] for controlling principles. Differentiating between primary-line and secondary-line price discrimination, the court distinguished the instant, secondary-line case from *Moore*, a primary-line case, on two grounds. First, since defendant in the instant case was neither cutting prices charged to intrastate competitors of the plaintiff nor subsidizing those price cuts with profits derived from interstate sales at higher prices, the court asserted that the impermissible "underwriting" practice found in *Moore* was not present here. Secondly, the court noted the absence in the instant case of the interlocking management and pattern for monopolistic growth that it deemed a decisive factor in *Moore*. Finding *Borden*, a secondary-line case, more analogous, the court observed that even though defendant seller in that case was engaged in interstate activity, as in the instant case, the *Borden* court had refused jurisdiction under section 2(a). The court acknowledged, however, the factual distinction that, unlike plaintiff in the instant case, plaintiff in *Borden* had failed to establish that any of defendant's *sales* had been made interstate. Recognizing the instant dispute, therefore, to be one of first impression falling between *Moore* and *Borden*, the court turned to the specific language of section 2(a):[43] "where either or any of the purchases *involved* in such discrimination are in commerce . . . ." (emphasis added). Construing the word "involved" in light of the purpose of antitrust laws to protect competition, and fortified by later references in section 2(a) to "competition,"[44] the court concluded that only those purchases by plaintiff or its actual competitors could be considered in determining whether "either or any" discriminatory sale was "in commerce."[45] Implicitly adopting

40. The court noted that the "in commerce" requirement of the Sherman Act has been read much more broadly by the courts than the same requirement under the Robinson-Patman Price Discrimination Act. 486 F.2d at 767.

41. 348 U.S. 115 (1954).

42. 339 F.2d 953 (7th Cir. 1964).

43. Citing a statement made in a case comment, 86 HARV. L. REV. 765, 769 (1973), that congressional intent in § 2(a) is unusually difficult to decipher from the legislative history, the court declined to discuss the legislative history. 486 F.2d at 767.

44. The word "competition" appears twice in § 2(a). Where the effect of price discrimination "may be substantially to lessen *competition* or . . . to injure, destroy, or prevent *competition*" (emphasis added) it is unlawful. For the pertinent text of § 2(a) see note 3 *supra*.

45. The court characterized the "in commerce" jurisdictional requirement as an ana-

the traditional state-line test of the scope of the section 2(a) "in commerce" requirement, the court suggested in dictum[46] that an interstate sale, even though not to a competitor, might satisfy the jurisdictional prerequisite in a *primary-line case* when used to underwrite intrastate price cuts. The court held, however, that in a *secondary-line case*, one of the discriminatory sales must not only cross a state line, but must also be to an *actual competitor* of the disfavored purchaser.

In a forceful dissent, Mr. Justice Clark[47] asserted that the record demonstrated that plaintiff had indeed attempted to compete with defendant's Indiana customers, but had been precluded from successful competition by defendant's discriminatory pricing.[48] Given this fact, he reasoned, the majority opinion implicitly subjected plaintiff to a vicious circle; it permitted defendant to charge discriminatory prices with the effect of precluding plaintiff from interstate competition and then denied plaintiff the protection of section 2(a) because he was not a competitor with the interstate customer. Such a reading, he noted, subverted the protective purpose of section 2(a). Mr. Justice Clark then concluded that the jurisdictional requirement of section 2(a) was satisfied when plaintiff established that a discriminatory sale was made across a state line; proof of actual or potential competition becomes crucial, he stated, only as to the question of damages.

Since the instant court announces that this is a case of first impression, it is important to delineate carefully the court's holding. The court held only that section 2(a) does not reach discriminatory intrastate sales to competing purchasers where the seller also makes an interstate sale at favorable prices to a purchaser with whom the disfavored intrastate purchaser is not competing. The majority did not meet the issue of potential competition raised by the dissent, ostensibly because plaintiff did not allege it.[49] If plaintiff in fact attempted to compete with defendant's Indiana purchasers and was prevented from so doing by defendant's discriminatory pricing, then the dissent's argument would seem compelling.[50] To argue that a purchaser totally cut off from interstate competition by a seller's

logue to standing and then stated that "[t]he customer has standing only to raise and compare those sales which are injurious to his competition." 486 F.2d at 770.

46. 486 F.2d at 770.

47. Mr. Justice Clark, formerly of the United States Supreme Court, sitting by designation.

48. *But see* note 6 *supra*.

49. *Id.*

50. *See* text accompanying notes 47 and 48 *supra*.

discriminatory prices may not invoke the protection of section 2(a) because he is not a "competitor" would contravene the recognized antitrust policy of promoting fair competition. Indeed, preclusion from competition by price discrimination arguably results in a greater degree of injury to the disfavored purchaser than would the clearly prohibited "lessening" of *existing* competition by discriminatory practices.[51] Assuming, however, that this issue properly was not decided by the majority, the instant holding on its face comports with recent primary-line cases, which have held that one of the discriminatory sales must cross a state line before jurisdiction under section 2(a) may be invoked.[52] Furthermore, a literal reading of the language of section 2(a) seems to require, as the majority held, that only those sales actually involved in the discrimination may be considered in the threshold jurisdictional determination of whether such sales were "in commerce." As previsouly noted, however, the legislative history indicates the congressional intent that section 2(a) reach to the extent of federal authority to legislate under the commerce power.[53]

Several commentators, pointing to the courts' treatment of the analogous Sherman Act commerce requirement, have argued that a judicial broadening of the commerce requirement of section 2(a) is appropriate.[54] Although the instant court consciously sidestepped this opportunity,[55] the Ninth Circuit recently seized it in *Copp Paving Co. v. Gulf Oil Co.*[56] In that case, defendant allegedly discriminated against plaintiff in strictly intrastate sales of asphalt used for building interstate highways. The court recoguized that the statu-

51. "It shall be unlawful . . . to discriminate in price . . . where the effect of such discrimination may be substantially *to lessen competition* . . . or *prevent competition* . . . ." Robinson-Patman Act § 2(a), 15 U.S.C. § 13(a) (1970) (emphasis added).

52. *See, e.g.,* Littlejohn v. Shell Oil Co., 483 F.2d 1140 (5th Cir.) *(en banc), cert. denied,* 94 S. Ct. 849 (1973); Food Basket, Inc. v. Albertson's, Inc., 383 F.2d 785, 787 (10th Cir. 1967). Although these decisions apparently restrict the Supreme Court's broad holding in *Moore,* some commentators have suggested that the Court's denial of certiorari in Cream Crest-Blanding Dairies v. National Dairy Prods. Corp., 370 F.2d 332 (6th Cir.), *cert. denied,* 387 U.S. 930 (1967), and in Willard Dairy Corp. v. National Dairy Prods. Corp., 309 F.2d 943 (6th Cir. 1962), *cert. denied,* 373 U.S. 934 (1963), amounts to a ratification of the narrower readings in these subsequent decisions. *See, e.g.,* Kintner & Mayne, *supra* note 7, at 1133.

53. *See* notes 21 and 22 *supra* and accompanying text.

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54. *Id. See also* Note, *The Commerce Requirement of the Robinson-Patman Act,* 22 HASTINGS L.J. 1245 (1971). For an interesting counterargument see 86 HARV. L. REV. 765, 771-72 (1973).

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

56. No. 72-2152 (9th Cir., Oct. 3, 1973), *petition for cert. filed,* 42 U.S.L.W. 3424 (No. 73-1012). This decision was handed down only 2 days after the instant decision.

tory language of the Robinson-Patman Act and Clayton Act is not so broad and flexible as that of the Sherman Act, but it nevertheless asserted that since those two Acts were intended to supplement the purpose and effect of the Sherman Act, the "in commerce" requirements of all three Acts should be interpreted uniformly. Rejecting the defendant's contention that section 2(a) requires a sale across state lines in all cases, the *Copp* court held that when the intrastate sale of a commodity (such as asphalt used in the construction of interstate highways) is closely linked to an "instrumentality of interstate commerce," the "nexus" of the sale with the instrumentality satisfies the "in commerce" requirement. Given the requisite "nexus," the court reasoned, the sale need not also satisfy a state-line test of "in commerce." *Copp Paving's* significance lies in its explicit expansion of the scope of the interstate commerce requirement of section 2(a). Nevertheless, its holding is limited to intrastate sales of commodities that are closely linked with an instrumentality of interstate commerce; it thus may be characterized as but another method, like the flow of commerce doctrine, for circumventing the inflexible state-line test in special factual situations. Although it cursorily dismisses the legislative history of section 2(a) as undecipherable[57] and consciously sidesteps the issue of constitutional authority to legislate under the commerce power, the instant decision is technically acceptable, and its reasoning is in the mainstream of judicial construction of section 2(a). It may, however, restrict the scope of the "in commerce" jurisdictional requirement in secondary-line cases to an even greater extent than in the recent primary-line decisions that have narrowed the *Moore* holding. Although *Moore* and subsequent primary-line decisions have consistently required that at least one of defendant seller's sales cross a state line,[58] this interstate sale may be to a purchaser for whose business plaintiff is not even competing. The jurisdictional requirement under section 2(a) is satisfied by *any* interstate sale in primary-line cases; if the interstate nexus does not result from the interstate sale's direct involvement in the discrimination, it generally will be found in the use of profits from the *interstate* sale to underwrite the *intrastate* discrimination.[59] Secondary-line price dis-

57. *See* note 43 *supra*.

58. *See* cases cited note 52 *supra*.

59. Indeed, the courts seem to require little proof that such profits actually were used to underwrite the discriminatory price-cuts. Rather, since the discrimination is effected by the offending seller's lowering his prices below those of his competitor, and even occasionally below the cost of the product being sold, the courts apparently *presume* that such interstate profits are used to subsidize the discrimination.

crimination, however, results not from undercutting a competing seller's prices, but from charging a disfavored purchaser higher prices than those charged his competitors. The underwriting theory presumably is not available to provide the interstate nexus between the intrastate price discrimination and an otherwise unrelated interstate sale by defendant seller, because, as the instant court implies, there will be no need to underwrite discriminatory price *hikes*. Thus, whereas section 2(a) may regulate intrastate price discrimination in primary-line cases by defendant sellers who also make sales that cross state lines, the instant decision results in denying section 2(a) protection against intrastate price discrimination in secondary-line cases, even though defendant seller also makes a sale across a state line. This result does not seem warranted in light of Congress' apparent intent to prohibit price discrimination occurring intrastate as well as interstate whenever it affects interstate commerce.[60] The instant decision seemingly would allow a large interstate business to immunize itself from the sanctions of section 2(a) merely by taking care that its discriminatory sales to favored and disfavored competing purchasers both occur within one state. The decision similarly implies that a disfavored purchaser who does not compete interstate would be deprived of the Act's protection when the favored purchaser was in interstate operation, so long as all purchases by both were within the state. The instant court did not base its decision on the argument that the potential conflict in policies of price regulation and antitrust law[61] justifies restraint in the regulation of price discrimination. This argument, however, would provide little support for the instant decision. Restraint in the regulation of price discrimination is aimed toward preventing price uniformity, not toward preventing price discrimination. To the extent that a seller's pricing practices result in unlawful discrimination, a seller involved in interstate commerce should not be able to avoid the sanctions of section 2(a) through unjustifiably technical jurisdictional requirements.

60. *See* note 21 *supra* and accompanying text.
61. *See* notes 23-25 *supra* and accompanying text.

Constitutional Law—Equal Protection—Exclusion of Pregnancy-Related Disabilities from State Salary Compensation Insurance Program Denies Equal Protection to Pregnant Employees

Plaintiffs, female employees, were denied salary compensation insurance for pregnancy-related work losses[1] solely on the basis of section 2626 of the California Unemployment Insurance Code,[2] which exempts such losses from the coverage of the state disability insurance program for a period of twenty-eight days after termination of pregnancy. Maintaining that section 2626 constitutes a denial of equal protection of the laws contrary to the fourteenth amendment,[3] plaintiffs initiated a class action to recover compensation.[4] They asserted first that sex is a suspect category and the statute is unconstitutional under a strict scrutiny standard. Alternatively, they argued that the court should adopt a new intermediate test stricter than the traditional rational basis standard for determining the constitutionality of discrimination based upon sex.[5] Defendant, California Department of Human Resources, contended that the exclusion of pregnancy-related disabilities is necessary primarily to protect the financial solvency of the mandatory insurance program,[6] which is funded entirely by employee contributions specifically limited by statute to one percent of wages.[7] The defendant

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1. The five named plaintiffs' disability claims were based upon an ectopic pregnancy, a tubal pregnancy, one miscarriage and two claims alleging general physical incapacitation.

2. "'Disability' or 'disabled' includes both mental or physical illness and mental or physical injury. An individual shall he deemed disabled in any day in which, because of his physical or mental condition, he is unable to perform his regular or customary work. In no case shall the term 'disability' or 'disabled' include any injury or illness caused by or arising in connection with pregnancy up to the termination of such pregnancy and for a period of 28 days thereafter." CAL. UNEP. INS. CODE § 2626 (West 1972).

3. U.S. CONST. amend. XIV, § 1. In pertinent part § 1 reads: "No State shall. . . deny to any person within its jurisdiction the equal protection of the laws."

4. Plaintiffs, on behalf of themselves and other women similarly situated, asked the court to enjoin the State Department of Human Resources Development from denying benefits on the basis of § 2626 and to require the Department to consider plaintiffs' claims as if § 2626 did not exist.

Eligible employees receive benefits varying between $25 and $105 per week depending upon the amount earned during a base period for a maximum of 26 weeks. CAL. UNEP. INS. CODE §§ 2653, 2655 (West 1972).

5. 359 F. Supp. 792, 796 (N.D. Cal. 1973).

6. Defendant argues that pregnancy-related disabilities are unique in that coverage is so extraordinarily expensive that it would be impossible to maintain a program supported by employee contributions if these disabilities are included. The court admitted that the postulated cost increase would require an approximately 37% increase in annual premiums and would result in raising the maximum annual contribution from $85 to $119.

7. Employees must contribute 1% of their salaries up to a maximum of $85 per year.

also alleged that the exclusion eliminates the administrative difficulty of determining when a pregnancy-related disability begins;[8] prevents abuse of the program by noncareer oriented women;[9] and ensures that women will not receive a disporportionate share of the benefits of the program.[10] A three judge federal court[11] for the Northern District of California *held*, judgment for plaintiffs. Section 2626 of the California Unemployment Insurance Code, which excludes pregnancy-related disabilities from salary compensation insurance coverage, is not based upon a classification having a rational and substantial relationship to a legitimate state purpose and therefore deprives pregnant employees of equal protection of the law. *Aiello v. Hansen*, 359 F. Supp. 792 (N.D. Cal. 1973), *review granted*, 42 U.S.L.W. 3358 (U.S. Dec. 18, 1973).

The California Unemployment Insurance Code establishes a comprehensive legislative scheme designed to provide protection against wage losses caused by involuntary unemployment.[12] The disability insurance program provides cash benefits to persons incapacitated as a result of nonjob-related illnesses and injuries with the sole exceptions of institutionalized psychopaths[13] and pregnant women.[14] In 1958, the California Supreme Court in *Clark v. California Employment Stabilization Commission*[15] rejected an equal protection challenge to section 2626, finding that under the traditional rational basis test the statute did not discriminate unconstitutionally against pregnant employees.[16] Under a stricter equal protec-

To be eligible to receive benefits, an employee must have contributed 1% of a minimum income of $300 during a one year base period. CAL. UNEP. INS. CODE §§ 984, 985, 2901, 2652 (West 1972).

8. 359 F. Supp. at 800.

9. *Id.* The court noted that whereas women contribute 28% of the total disability insurance fund, they receive 38% of the funds in benefits.

10. *Id.*

11. The 3-judge court was convened pursuant to 28 U.S.C. § 2281 (1970), which requires a 3-member court when the injunction of a state statute is involved.

12. The disability insurance program provides benefits to persons unable to work because of almost any nonjob-related disability. A complementary program provides compensation to unemployed persons able to and available for work. CAL. UNEP. INS. CODE §§ 100, 2601 (West 1972). Job-related disabilities are dealt with under workmen's compensation. CAL. LABOR CODE § 3201 (West 1971).

13. Institutionalized dipsomaniacs, drug addicts, and sexual psychopaths are disqualified from receiving benefits while confined. CAL. UNEP. INS. CODE § 2678 (West 1972).

14. CAL. UNEP. INS. CODE § 2626 (West 1972).

15. 166 Cal. App. 2d 326, 332 P.2d 716 (1958).

16. The "rational basis" test used in *Clark* presumes the constitutionality of the challenged statute and requires that the classification drawn by the statute bear some rational relation to a legitimate state goal. Classifications, however, will only be set aside if no grounds can be *conceived* to justify them. *See* Dandridge. v. Williams, 397 U.S. 471, 485 (1970); McDonald v. Board of Election Comm'rs, 394 U.S. 802, 809 (1969).

tion standard certain classifications are presumed unconstitutional and are subjected to the most rigid scrutiny, which a statute can survive only if it forwards a "compelling state interest."[17] To qualify for this "strict scrutiny" standard the challenged classification must be based upon a "suspect" criterion such as race,[18] or infringe upon a "fundamental right" such as the right to vote.[19] Confronted with a choice of standards, scholars and justices have realized that neither test allows equal protection cases to be tried upon their facts nor eliminates judicial subjectivity. Because neither test affords leeway for the balancing of the opposing interests, the court in effect predetermines the outcome by deciding which test to apply.[20] While not overruling past precedent based on strict scrutiny, the Burger Court, cognizant of these handicaps suffered under the "two-tiered"[21] system, has been disinclined to expand the list of fundamental rights and suspect categories.[22] Instead, an intermediate third standard, "substantial rationality"[23] or "newer equal protection,"[24] emerged in a series of equal protection cases beginning in 1971.[25] Unlike the traditional passive rational basis standard, the newer "substantial rationality" requires that a discriminating statute must substantially forward an actual legislative purpose.[26] Although it has not expressly enunciated this test,[27] the Court has

17. *See* Shapiro v. Thompson, 394 U.S. 618 (1969). In its entire history only one statute has withstood the withering gaze of "strict scrutiny." Korematsu v. U.S., 323 U.S. 214 (1944). *See* Note, *The Decline and Fall of the New Equal Protection: A Polemical Approach*, 58 VA. L. REV. 1489, 1495 (1972). [hereinafter cited as 58 VA.]

18. Graham v. Richardson, 403 U.S. 365 (1971).

19. *See* Dandridge v. Williams, 397 U.S. 471 (1970). For an excellent in-depth analysis of traditional rational basis and strict scrutiny see Note, *Developments in the Law: Equal Protection*, 82 HARV. L. REV. 1065 (1969).

20. *See* Note, *Equal Protection and the Pregnancy Leave Cases*, 34 OHIO ST. L.J. 628, 644 (1973); 58 VA., *supra* note 17, at 1495.

21. Gunther, *The Supreme Court, 1971 Term—Forward: In Search of Evolving Doctrine on a Changing Court: A Model for a Newer Equal Protection*, 86 HARV. L. REV. 1, 8 (1972) [hereinafter cited as 86 HARVARD].

22. *See* Cohen v. Chesterfield County School Bd., 42 U.S.L.W. 4186 (U.S. Jan. 21, 1974); Reed v. Reed, 404 U.S. 71 (1971); 86 HARVARD, *supra* note 21, at 12.

23. Note, *supra* note 20.

24. *Id.* at 641.

25. *See* Vlandis v. Kline, 412 U.S. 441 (1973); Police Dept. v. Mosley, 408 U.S. 92 (1972); Bullock v. Carter, 405 U.S. 134 (1972); Stanley v. Illinois, 405 U.S. 645 (1972); Mayer v. Chicago, 404 U.S. 189 (1971); Reed v. Reed, 404 U.S. 71 (1971); Phillips v. Martin Marietta Corp., 400 U.S. 542 (1971) (*per curiam*). *But see* Jefferson v. Hackney, 406 U.S. 535 (1972); Schilb v. Keubel, 404 U.S. 357 (1971); Richardson v. Belcher, 404 U.S. 78 (1971) in which the Court apparently relied upon the traditional rational basis test.

26. Reed v. Reed, 404 U.S. 71, 75-76 (1971).

27. While the instant case marks the first time a majority of any court has openly admitted altering traditional rational basis, such action has been acknowledged by concur-

been less willing to supply justifying rationales, demanding proof of actual legislative purposes and not mere conjecture from the proponents of the questioned statute.[28] Furthermore, the reasonableness of the statute is judged upon verifiable evidence rather than judicial hypothesis.[29] The Supreme Court first applied the new standard in the 1971 decision of *Reed v. Reed*,[30] inpalidating an Idaho probate code provision preferring males to females as administrators. Although the majority claimed to apply the traditional rational basis test it did find that the classification served the legitimate purpose of reducing the work loads of the probate courts.[31] This was the first classification based upon sex to be held unconstitutional.[32] The Court's refusal, however, to enunciate clearly the proper equal protection standard to use in sex discrimination cases introduced a welter of confusion in the lower courts. In a 1973 decision, *Green v. Waterford Board of Education*,[33] the Second Circuit became the first federal court to expressly acknowledge the use of the new substantial rationality test and operating thereunder overturned a forced maternity-leave statute. The Fourth Circuit, however, employing the traditional rational basis standard, upheld a similar maternity-leave statute in *Cohen v. Chesterfield County School Board*[34]—a dichotomy resulting primarily from uncertainty as to which standard to apply.[35] Subsequently, the situation was clouded further by *Frontiero v. Richardson*[36] in which eight Justices struck down a

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ring Supreme Court Justices. Vlandis v. Kline, 93 S.Ct. 2230, 2238 (1973) (White, J., concurring).

28. *See* Police Dept. v. Mosley, 408 U.S. 92 (1972); Stanley v. Illinois, 405 U.S. 645 (1971); 86 HARVARD, *supra* note 21, at 19.

29. *See* Police Dept. v. Mosley, 408 U.S. 92 (1972); Stanley v. Illinois, 405 U.S. 645 (1971); 86 HARVARD, *supra* note 21, at 19.

30. 404 U.S. 71 (1971). The court stated that: "[a] classification 'must be reasonable, not arbitrary, and must rest upon some ground of difference having a *fair and substantial relation* to the object of the legislation . . . .'" [emphasis added]. *Id.* at 76 *citing* Royster Guano Co. v. Virginia, 253 U.S. 412, 415 (1920).

31. The court held that sex based discrimination implemented only to forward administrative expedience is the kind of arbitrary legislative choice forbidden by the equal protection clause. 404 U.S. at 76.

32. *See* Note, *Constitutional Law: The Equal Protection Clause and Women's Rights*, 19 LOYOLA L. REV. 542, 547 (1973).

33. 473 F.2d 629 (2d Cir. 1973).

34. 474 F.2d 395 (4th Cir.), *cert. granted*, 93 S. Ct. 1925 (1973).

35. *See* 1972 WISC. L. REV. 626.

36. 93 S. Ct. 1764 (1973). In addition to constitutional questioning, sex discrimination has also been attacked via Title VII of the Civil Rights Act of 1964. 42 U.S.C. § 2000e (1970). Title VII makes sex-based discrimination with respect to "compensation, terms, conditions, or privileges of employment" an unlawful employment practice. 42 U.S.C. § 2000e-2(a)(1) (1970). As interpreted by Equal Employment Opportunity Commission regulations, Title VII forbids employers to exclude pregnancy-related disabilities from applicable insurance cover-

provision under a federal statute disallowing dependents' allowances to female members of the armed forces who failed to prove the economic dependence of the male spouse. Four Justices declared sex a suspect classification,[37] and three others concurred on the basis of *Reed.*[38]

The instant court initially observed that a majority in *Frontiero* did not label sex as a suspect classification. Relying upon *Green,*[39] the court applied a "slightly, but perceptibly, more rigorous" rational basis test[40] that requires that classifications be fairly and substantially related to the object of the legislation. Pointing out that the only expressed purpose of the insurance program is to reduce disability-related economic suffering to a minimum,[41] the court reasoned that this was not a legitimate purpose for the challenged exclusion since the economic hardship on pregnant women is identical to that of other disabled workers. Turning to the unexpressed purposes that were claimed to have been promoted by the exclusion, the court examined defendant's main contention that the prodigious expense of insuring pregnancy-related disabilities would render the employee-financed program insolvent. The court acknowledged the propriety of preserving a program's fiscal integrity, but required that the instant exclusion be shown to rest on some distinction fairly and substantially related to the object of the statute. It decided, therefore, that pregnancy-related disabilities cannot be excluded merely to reduce costs, and concluded that if a state wishes to save expenses by limiting large claims it must do so by limiting all claims in excess of certain amounts regardless of the nature of the disability.[42] Evaluating proferred secondary purposes for the exclusion, the court recognized that women contributed

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age. 29 C.F.R. § 1604.10(b) (1973). It should be noted, however, that this regulation applies only to insurers that are also employers, labor organizations, and employment agencies. *Id.* at § 1604.1(a). It does not apply to insurers who are not also employers of the insured workers.

37. 93 S. Ct. at 1768.

38. *Id.* at 1773.

39. 473 F.2d 629 (2d Cir. 1973).

40. 359 F. Supp. at 796 *citing* Green v. Waterford Bd. of Educ., 473 F.2d 629, 633 (2d Cir. 1973).

41. CAL. UNEP. INS. CODE § 2601 (West 1972).

42. 359 F. Supp. at 799. The court pointed out that the entire expense of the proposed addition could be met by increasing the maximum contribution level and premiums approximately 40%. The court further determined that *all* preguancy-related disabilities cannot be constitutionally excluded because of the expense of providing coverage for the entire group. The belief that all pregnant women are incapable of work for extended periods resulting in large claims was debunked by the court as a stereotypical generalization rejected in analogous maternity leave cases. *See* Struck v. Secretary of Defense, 460 F.2d 1372, 1377 (9th Cir.), *vacated and remanded to consider mootness,* 409 U.S. 1071 (1972).

twenty-eight percent of total premiums and received thirty-eight percent of the benefits. Nevertheless, the majority found that in the absence of an overall attempt to distribute benefits based upon a claimant's percentage of contribution,[43] such actuarial concepts could not be utilized to limit the compensation of a class simply because it would result in women receiving a disproportionate share of benefits.[44] The contention that the exclusion prevents abuse of the program by noncareer oriented women who voluntarily become pregnant and collect a substantial award with no intention of returning to work was likewise rejected as irrational and arbitrary. The court emphasized that while many pregnancy-related disabilities are not voluntarily incurred,[45] every other voluntarily incurred disability is covered.[46] Finally, the court discredited the assertion that section 2626 is necessary to avoid the difficulty of determining when a pregnant woman is truly disabled. The majority stated that a disability is no more easily diagnosed twenty-eight days after pregnancy than before.[47] Having found that the statute was not based upon a classification having a rationale and substantial relationship to a legitimate state purpose, the court concluded that the exclusion of pregnancy-related disabilities is unconstitutonal. In a dissenting opinion Judge Williams argued that the disability program had been envisioned as an insurance program with the objective of providing the broadest coverage and maximum benefits possible within the limits of a one percent contribution rate. He concluded that a desire to provide the broadest coverage possible to the entire working population, coupled with a limited contribution rate lends rationality to the challenged exclusion.[48]

Subsequent to the instant decision, the repercussions of *Frontiero* were manifested in *Hanson v. Hutt*[49] when the Washington Supreme Court held sex to be a suspect classification and struck down a state employment compensation law that disqualified specified pregnant women from benefits.[50] Nevertheless, the Supreme

43. It should be noted, however, that the majority did not say that the presence of an attempt to distribute benefits based upon a claimant's percentage of contribution necessarily would lend constitutionality to the challenged exclusion. 359 F. Supp. at 800.

44. *Id.*

45. The court emphasized that three of plaintiffs' disabilities resulted from an ectopic pregnancy, tubal pregnancy, and miscarriage—none voluntarily incurred. *Id.*

46. The statute even covers cosmetic plastic surgery. *Id.*

47. *Id.* at 801.

48. *Id.* at 803-04, 806.

49. 42 U.S.L.W. 2372 (Dec. 20, 1973).

50. The statute disqualified pregnant women from benefits during the period between the seventeenth calendar week prior to the expected date of delivery and the sixth calendar week thereafter.

Court, in an apparent retreat from its holding in *Frontiero*, demonstrated its reluctance to designate sex definitively as a suspect category in *Cleveland Board of Education v. La Fleur*,[51] finding that a mandatory school teacher maternity leave statute violated due process.[52] While three justices maintained that the equal protection clause should have been implemented,[53] no member of the Court alluded to sex as a suspect classification. Therefore, the uncertainty as to the equal-protection standard to apply to challenged sex-based classifications after *La Fleur* is substantially the same as it was at the time of the instant decision.

The instant decision not only helps alleviate confusion as to the proper test to apply in sex discrimination cases, but also formally endorses a much needed alteration of the two-tiered equal-protection standard. The new substantial rationality, neither limited by decisions based upon judicial conjecture, as is old rational basis, nor cursed with the predisposed inflexibility of strict scrutiny,[54] should prove to be a viable compromise in sex discrimination litigation.[55] Whereas some commentators feel that reasonable scrutiny will be limited to sex discrimination cases,[56] the instant court correctly indicated that the Supreme Court intended the new standard to embrace the entire spectrum of equal protection not presently subject to the strict scrutiny test.[57] The new "reasonableness"

51. ___ U.S. ___, 42 U.S.L.W. 4186 (U.S. Jan. 21, 1974). The Sixth Circuit, employing the substantial rationality standard, had declared the questioned mandatory leave statute to be violative of equal protection. 465 F.2d 1184 (6th Cir. 1973).

52. ___ U.S. at ___, 42 U.S.L.W. at 4191.

53. Justice Powell, concurring, and Justice Rehnquist, with whom the Chief Justice joined in dissent, maintained that equal protection was the proper standard to apply. *Id.* at 4192, 4194.

54. *See* text accompanying note 20 *supra*.

55. Under the new standard a challenged classification will survive only if it is reasonable, not arbitrary, and *substantially* forwards a legitimate state purpose. No longer may the reasonableness of a statute and the propriety of its purpose be grounded upon judicial hypothesis and conjecture. The new test, to the contrary, demands that defendant establish a legitimate need for the challenged classification with proof based upon verifiable evidence and statistics or fail. *See* 86 HARVARD, *supra* note 21, at 21. Furthermore, the more equitable results of substantial rationality attenuate the possibility that classifications will be invalidated without a hearing on the merits—the result of the strict scrutiny test. This is particularly significant since an in-depth judicial investigation is needed whenever sex is involved—for even the instant plaintiffs admitted that some sex-based classifications are permissible. 359 F. Supp. at 802.

56. *See, e.g.*, Krauskopf, *Sex Discrimination—Another Shibboleth Legally Shattered*, 37 Mo. L. REV. 377, 387 (1972).

57. The Court has utilized the new standard in equal protection suits far removed from questions of sex discrimination. *See, e.g.*, Police Dept. v. Moseley, 408 U.S. 92 (1972) (ordinance forbidding all picketing and demonstrating, except by labor unions, within 150 feet of a school in session held to be unconstitutional).

does not require unanimity of thought, but only substantial rationality based upon facts. The Supreme Court recently commented: "The very complexity of . . . [social and economic] problems suggests that there will be more than one constitutionally permissible method of solving them."[58] Therefore, to operate as a viable alteration of the inflexible "two-tiered" approach, application of the new standard must be based not upon a substitution of judicial wisdom, but upon an objective evaluation of facts. Despite the instant court's express adoption of the new standard, apparently it did not consistently apply the required objectivity to the instant issue. For instance, the majority summarily dismissed the contention that the exclusion of pregnancy-related disabilities prevents abuse of the program by pregnant employees who receive benefits with no intention of returning to work. Surveys indicate, however, that while approximately one hundred percent of those who recover from short term disabilities continue their employment, forty to fifty percent of female employees who give birth do not return to work.[59] The inclusion of all pregnancy-related disabilities, as demanded by the court, would indeed create a major drain upon the program's funds in contradiction of the legislature's goal of supplying funds to disabled employees during *temporary* absences. Furthermore, the Supreme Court has long maintained, as recognized by the instant majority, that fiscal considerations are legitimate concerns "in the area of economics and social welfare."[60] In creating a benefits program, a state seeks a balanced package of many benefits that best serve overall employee needs. Since no benefits package can satisfy all wants of all employees, a state must seek to utilize its benefits dollars in the best overall way.[61] The instant court admits that the proposed extension of coverage would increase the contribution level and premiums approximately forty percent.[62] Furthermore, separate studies indicate that the annual cost of adding the requested benefits to disability plans now in effect in the United States would be in excess of 1,300,000,000 dollars.[63] National statistics from the

58. Jefferson v. Hackney, 406 U.S. 535, 546-47 (1972) *citing* Dandridge v. Williams, 397 U.S. 471, 485 (1970).

59. Post-Trial Brief for Defendant at 61 n.73, Gilbert v. General Elec. Co., ___ F. Supp. ___ (E.D. Va. 1974), [hereinafter cited as Post-Trial Brief].

60. Jefferson v. Hackney, 406 U.S. 535, 546 (1972); Dandridge v. Williams, 397 U.S. 471, 485 (1970). The dissent in the instant decision concurs. 359 F. Supp. at 805.

61. *See* Post-Trial Brief, *supra* note 59, at 59.

62. The court stated that the cost increase could be met by requiring workers to contribute an additional .364% of their salary and increasing the maximum annual contribution from $85 to $119. 359 F. Supp. at 798.

63. *See* Post-Trial Brief, *supra* note 59, at 65. One of the studies was made by Alexander

closely analogous employee sickness and accident insurance plans reveal that, whereas the cost per unit of benefit for a female employee is approximately 170 percent of that for a male employee when no maternity benefits are provided, the female cost per unit of benefit exceeds male costs by over 300 percent when full maternity benefits are provided.[64] In light of these facts the legislature's decision to delete pregnancy-related disabilities appears neither arbitrary nor unreasonable. Although it may be argued that section 2626 is thus constitutionally sound, it nevertheless is apparent that approximately fifty percent of pregnant workers could benefit legitimately from the additional coverage due to their intent to return to work after pregnancy. Numerous legislative alternatives are available that would mitigate the financial strain of either total coverage or noncoverage on all parties. First, defendant's fear of program abuse by women seeking employment primarily to finance delivery of their children could be eliminated entirely by requiring female workers to sign a letter of intent to return to work in the event they become pregnant and give birth. Only women so agreeing would be afforded maternity coverage. The statement would necessarily contain a confession of judgment in the amount of benefits received to guard against unscrupulous employees who violate their pledges. Based upon statistics of women who presently do not return to work after giving birth, this would reduce claims and, therefore, costs forty to fifty percent.[65] Secondly, because of the extraordinary expense of pregnancy-related disability coverage and the fact that modern contraceptives have for all practical purposes, rendered pregnancy a voluntary condition, it has been suggested that employees should be given the option of maternity coverage, but only if they are willing to bear a portion of the additional cost. Perhaps the best approach would be a combination of these two suggestions with the state insurance program bearing a portion of the increased cost. Mandatory letters of intent to return to work—entailing a cost reduction of fifty percent—coupled with participants contributing one half of the pregnancy-related premiums would reduce the economic drain on the diability insurance program by seventy-five percent. This plan would limit the program to persons intending to return

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Bailie, the actuary in charge of actuarial functions for group insurance for Metropolitan Life Insurance Co. and a Fellow in the Society of Actuaries. *Id.* at 65 n.77. Presently, only 4 other states plus a number of private concerns offer disability insurance covering pregnancy-related disabilities. Walker, *Sex Discrimination in Government Benefit Programs*, 23 HASTINGS L.J. 277, 285 (1971).

64. *See* Post-Trial Brief *supra* note 59, at 64.

65. *See* text accompanying note 59 *supra*.

to the work force and provide the coverage at a much lower rate than available privately without placing an inequitable financial strain on nonpregnant members of the work force.[66]

Criminal Procedure—Grand Juries—Exclusionary Rule in Search and Seizure Cases Does Not Apply to Grand Jury Proceedings

Respondent, a witness before a federal grand jury investigating loansharking activities, refused to testify on the ground that its questions were based on evidence seized by federal agents from his place of business[1] during a search alleged to be violative of fourth amendment protections.[2] The evidence had been discovered during a search made pursuant to a warrant issued in connection with an investigation of illegal gambling operations. The warrant specified that the object of the search was the discovery and seizure of bookmaking records and wagering paraphernalia.[3] After a hearing on respondent's motion to suppress the evidence[4] under Rule 41(e) of

66. Two additional solutions have been suggested. First, most health insurance policies do not provide benefits for conditions that predate the time of hire or require a one year waiting period for maternity benefits. A waiting period would prevent women from seeking a job primarily to finance delivery of their children. Getman, *The Emerging Constitutional Principle of Sexual Equality*, 1972 S. CT. REV. 157, 178 (1972). Secondly, the California legislature in 1972 passed a bill (vetoed by tbe governor) that covered only abnormal complications of pregnancy, excluded disabilities arising from therapeutic abortions, and provided necessary financing by increasing the maximum annual contribution from $85 to $95. 359 F. Supp. 792, 804-05 (N.D. Cal. 1973) (dissenting opinion).

1. Respondent's home and automobile were also searched, but those searches were not involved in this litigation.

2. "The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing tbe place to be searched, and tbe persons or things to be seized." U.S. CONST. amend. IV.

3. An affidavit submitted in support of the application for the warrant contained information derived from statements by confidential informants of the F.B.I., from physical surveillance conducted by the F.B.I., and from court-authorized electronic survillance. During the search a federal agent found evidence linking respondent to a loansharking operation that the agent knew was under investigation by the United States Attorney's office.

4. Respondent initially bad refused to testify, invoking his fifth amendment privilege against self-incrimination. When the government requested the district court to grant respondent transactional immunity pursuant to 18 U.S.C. § 2514 (1970), because he was not the target of tbe loansbarking investigation, respondent succeeded in receiving a postponement of a hearing on the government's application so that he could prepare this motion to suppress the evidence.

the Federal Rules of Criminal Procedure,[5] the district court found that the search warrant had been issued without probable cause and the search had exceeded the scope of the warrant. The evidence was ordered returned to respondent, and it further was ordered that respondent need not answer any of the grand jury's questions based on the suppressed evidence.[6] The United States Court of Appeals for the Sixth Circuit affirmed,[7] holding that the exclusionary rule of the fourth amendment may be invoked by a witness before the grand jury to bar questioning based on evidence obtained in an unlawful search and seizure.[8] On writ of certiorari to the United States Supreme Court, *held*, reversed. Because an extension of the exclusionary rule to grand jury proceedings would achieve only a speculative and minimal advance in deterring police misconduct at the expense of substantially impeding the role of the grand jury, a witness before a grand jury may not refuse to answer questions on the ground that they are based on evidence seized from him in an unlawful search and seizure. *United States v. Calandra*, 94 S. Ct. 613 (1974).

The fourth amendment exclusionary rule, which renders otherwise reliable evidence inadmissible in court when obtained in an unlawful search and seizure,[9] is a doctrine of relatively recent origin.[10] Presently, it is the judiciary's sole method of protecting the vital constitutional guarantees of the fourth amendment against unreasonable searches and seizures; yet, its justifications and con-

5. The rule states in part: "A person aggrieved by an unlawful search and seizure may move the district court for the district in which the property was seized for the return of the property and to suppress for the use as evidence anything so obtained on the ground that (1) the property was illegally seized without warrant, or (2) the warrant is insufficient on its face, or (3) the property seized is not tbat described in the warrant, or (4) there was not probable cause for believing the existence of the grounds on which the warrant was issued, or (5) the warrant was illegally executed." FED. R. CRIM. P. 41(e).

6. *In re* Calandra, 332 F. Supp. 737 (N.D. Ohio 1971).

7. 465 F.2d 1218 (6th Cir. 1972).

8. The offer by the government to grant respondent immunity was deemed irrelevant to the decision. *Id.* at 1223.

9. The exclusionary rule also requires the suppression of confessions, Miranda v. Arizona, 384 U.S. 436 (1966), and identification testimony, United States v. Wade, 388 U.S. 218 (1967); Gilbert v. California, 388 U.S. 263 (1967), obtained in violation of the fifth and sixth amendments, as well as evidence obtained by means so shocking as to violate the fifth amendment due process clause, Rochin v. California, 342 U.S. 165 (1952).

10. Appearing initially as a suggestion in dicta in 1886, Boyd v. United States, 116 U.S. 616, the rule was applied by the Court in 1914 in its holding that illegally seized evidence is inadmissible in the federal courts when the seizure has been made by federal or state officers acting under color of federal authority. Weeks v. United States, 232 U.S. 383 (1914). In 1949, the fourth amendment freedom from unreasonable searches and seizures was applied to the states. Wolf v. Colorado, 338 U.S. 25 (1949). Twelve years later *Mapp v. Ohio* imposed the exclusionary rule on the states as a required method of enforcement. 367 U.S. 643 (1961).

stitutional foundations have been hotly debated, especially since *Mapp v. Ohio*[11] applied the rule to the states in 1961.[12] There, the Court termed the rule "logically and constitutionally necessary" and an "essential part of the right to privacy."[13] Prior to *Mapp*, the Court had not articulated any constitutional foundations for the rule with such clarity. It was spoken of as a remedy and its necessity was examined in the light of its practical justifications. The "normative" or "judicial integrity" rationale, which focuses on the evil of government participation in illegal police conduct, is advanced as one justification for the rule. In *Weeks v. United States*,[14] the Court that formulated the rule stated, "[t]o sanction such proceedings would be to affirm by judicial decision a manifest neglect if not open defiance of the prohibitions of the Constitution, intended for the protection of the people against such unauthorized action."[15] Although the normative rationale has received recognition in virtually every significant search and seizure case since *Weeks*,[16] the

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11. 367 U.S. 643 (1961).

12. *See, e.g.*, Burns, *Mapp v. Ohio: An All-American Mistake*, 19 DE PAUL L. REV. 80 (1969); Friendly, *The Bill of Rights as a Code of Criminal Procedure*, 53 CALIF. L. REV. 929, 951-53 (1965); Kamisar, *Wolf and Lustig Ten Years Later: Illegal State Evidence in State and Federal Courts*, 43 MINN. L. REV. 1083 (1959); LaFave, *Improving Police Performance Through the Exclusionary Rule*, 30 MO. L. REV. 391 (1965); LaFave & Remington, *Controlling the Police: The Judge's Role in Making and Reviewing Law Enforcement Decisions*, 63 MICH. L. REV. 987 (1965); Oaks, *Studying the Exclusionary Rule in Search and Seizure*, 37 U. CHI. L. REV. 665 (1970); Note, *Judicial Integrity and Judicial Review: An Argument for Expanding the Scope of the Exclusionary Rule*, 20 U.C.L.A. L. REV. 1129 (1973).

13. 367 U.S. at 656.

14. 232 U.S. 383 (1914).

15. *Id.* at 394. Perhaps the most eloquent spokesman for the judicial integrity rationale was Justice Brandeis, who, dissenting in Olmstead v. United States, 277 U.S. 438, 485 (1928), stated:

> Decency, security and liberty alike demand that government officials shall be subjected to the same rules of conduct that are commands to the citizen. In a government of laws, existence of the government will be imperilled if it fails to observe the law scrupulously. Our Government is the potent, the omnipresent teacher. For good or for ill, it teacbes the whole people by its example. Crime is contagious. If the Government becomes a lawbreaker, it breeds contempt for law; it invites every man to become a law unto himself; it invites anarchy. To declare that in the administration of the criminal law the end justifies the means—to declare that the Government may commit crimes in order to secure the conviction of a private criminal—would bring terrible retribution. Against that pernicious doctrine this Court should resolutely set its face.

One writer has criticized the proposition that the exclusionary rule is necessary for judicial integrity, however, by observing that no such rule exists in other common law jurisdictions such as England and Canada "whose courts are otherwise regarded as models of judicial decorum and fairness." Oaks, *supra* note 12, at 669.

16. *See, e.g.*, Terry v. Ohio, 392 U.S. 1, 12-13 (1968); Linkletter v. Walker, 381 U.S. 618, 636 (1965); Mapp v. Ohio, 367 U.S. 643, 659 (1961); Elkins v. United States, 364 U.S. 206, 223 (1960); Silverthorne Lumber Co. v. United States, 251 U.S. 385, 391-92 (1920).

recent trend has been to emphasize the "deterrence" rationale, a second justification for the rule, which assumes that the exclusion of evidence obtained by illegal means will deter law enforcement officers from engaging in illegal behavior.[17] The sources of this shift in emphasis are not clear. The leading cases, beginning with *Weeks*, made few references to the deterrence factor prior to 1960.[18] Rather, the Court was concerned with the thorny problem of the means by which a criminal defendant's fourth amendment rights could be protected comprehensively and with the continuing necessity of maintaining the integrity of the judicial process. In 1960, however, *Elkins v. United States*[19] established the doctrine that deterrence is the primary purpose of the exclusionary rule.[20] Justice Stewart, in an otherwise well-documented history of the rule, simply stated the deterrence rationale without citation to any previous decisions of the Court.[21] The present supremacy of the deterrence rationale has had a significant impact on the scope of the rule's application. The rule almost exclusively has been restricted to criminal trials,[22] any

17. *See, e.g.*, Coolidge v. New Hampshire, 403 U.S. 443, 488 (1971); Terry v. Ohio, 392 U.S. 1, 12-13 (1968); Linkletter v. Walker, 381 U.S. 618, 636-37 (1965); Mapp v. Ohio, 367 U.S. 643, 656 (1961); Elkins v. United States, 364 U.S. 206, 217 (1960). Deterrence was an important consideration in the Court's decisions on whether *Mapp* and the new rules on interrogation warnings and lineup formalities should have retrospective application. Linkletter v. Walker, 381 U.S. 618 (1965) (*Mapp*); Johnson v. New Jersey, 384 U.S. 719 (1966) (*Miranda* warnings); Stovall v. Denno, 388 U.S. 293 (1967) (lineup formalities).

18. In applying the fourth amendment prohibition against unreasonable searches and seizures to the states, the Court in *Wolf v. Colorado* recognized that "in practice the exclusion of evidence may be an effective way of deterring unreasonable searches . . . ." 338 U.S. 25, 31 (1949).

19. 364 U.S. 206 (1960).

20. "The rule is calculated to prevent, not to repair. Its purpose is to deter—to compel respect for the constitutional guaranty in the only effectively available way—by removing the incentive to disregard it." *Id.* at 217.

21. A dissenting opinion by Justice Jackson in Brinegar v. United States, 338 U.S. 160, 181 (1949), was quoted as support for Justice Stewart's conclusion. Justice Jackson's statement cannot be read, however, as an unqualified affirmance of the deterrence rationale. People v. Cahan, 44 Cal. 2d 434, 445, 282 P.2d 905, 911-12, 913 (1955), in which California adopted the exclusionary rule, was also quoted as support for the deterrence rationale.

22. In United States v. Blue the Court reversed a district court order dismissing an indictment for income tax evasion on the ground that evidence seized in violation of the fifth amendment (statements made by defendant in an earlier Tax Court proceeding) was used in returning an indictment. 384 U.S. 251 (1966). The Court stated,

> Even if we assume that the Government did acquire incriminating evidence in violation of the Fifth Amendment, Blue would at most be entitled to suppress the evidence and its fruits if they were sought to be used against him at trial. . . . Our numerous precedents ordering the exclusion of . . . illegally seized evidence assume implicitly tbat the remedy does not extend to barring the prosecution altogether. So drastic a step might advance marginally some of the ends served by exclusionary rules, but it would also increase to an intolerable degree interference with the public interest in having the guilty brought to book.

deterrent effect that might be achieved outside the trial setting being found too slight to justify expansion. Such a balancing approach would be inappropriate under the judicial integrity doctrine.[23] Reliance upon the deterrence rationale also has resulted in several specific criticisms of the exclusionary rule: (1) It is improbable that police will be deterred from illegal searches by a rule whose direct effects are felt only at the prosecutorial level; (2) Police often are not interested in convictions so much as in apprehension of suspects and in seizure of evidence such as weapons, narcotics, and gambling equipment that will endanger the public; (3) Police are more conscious of internal police norms—both superior officers and patrolmen often feeling that the courts are "tying the hands" of the police—than of external court decisions that are often too complex for the average policeman to understand.[24] These considerations have led to proposals for a fourth amendment remedy that would not exclude relevant evidence but would still deter unlawful police conduct. An effective tort action has been a commonly suggested vehicle.[25] The tort remedy proponents appear to assume that the exclusionary rule is ineffective as a deterrent and that deterrence is the primary rationale for invoking any remedy for an unconstitutional police search.[26] While critics of the exclusionary rule assert

Id. at 255.

The rule also has been denied application in sentencing proceedings, United States v. Schipani, 435 F.2d 26 (2d Cir. 1970), *cert. denied*, 401 U.S. 983 (1971), and parole revocation hearings, *In re* Martinez, 1 Cal. 3d 641, 463 P.2d 734, 83 Cal. Rptr. 382 (1970).

23. In *Blue* the Court indicated that it was balancing the deterrent effect of applying the exclusionary rule against the danger to society in allowing a guilty person to go free. Holmes and Brandeis in their *Olmstead* dissents recognized that one cost of unconstitutional police searches would be that guilty persons would be released. Olmstead v. United States, 277 U.S. 438, 470, 484 (1928). *See also* Bivens v. Six Unknown Fed. Narcotics Agents, 403 U.S. 388, 416 (1971) (Burger, C.J., dissenting); Davis v. Mississippi, 394 U.S. 721, 730 (1969) (Black, J., dissenting); Simmons v. United States, 390 U.S. 377, 397 (1968) (Black, J., dissenting).

24. See generally Oaks, *supra* note 12, at 706-54.

25. Chief Justice Burger hecame the leading spokesman for this position in his now famous dissent in Bivens v. Six Unknown Fed. Narcotics Agents. 403 U.S. 388 (1971). *See also* Foote, *Tort Remedies for Police Violations of Individual Rights*, 39 MINN. L. REV. 493 (1955); Oaks, *supra* note 12, at 717-19; *Symposium on Police Tort Liability*, 16 CLEV.-MAR. L. REV. 397 (1967).

Congress has entered the picture with proposed legislation providing that evidence would not be excluded if unlawfully seized unless the court, after considering all the circumstances surrounding the search, concluded that a "substantial" violation of the fourth amendment had occurred. The bill also would amend the Federal Tort Claims Act to provide the victim of an illegal search with the right to sue the government for damages in federal district court. S. 881, 93d Cong., 1st Sess. (1973). *See generally* Note, *Excluding the Exclusionary Rule: Congressional Assault on Mapp v. Ohio*, 61 GEO. L.J. 1453 (1973).

26. Chief Justice Burger's feelings on the deterrence factor were voiced long before his

that its effectiveness as a deterrent is doubtful, a majority of the Court has seemingly accepted the deterrence rationale as the paramount consideration for almost fifteen years. The theory has never been adequately tested—by the Court[27] or anyone else.[28] The defenders of the exclusionary rule generally have taken the position that it is "the best we have."[29] As noted by one commentator, "[t]he fact that there is little agreement and little evidence that the exclusionary rule does deter police lawlessness is much less significant . . . than the fact that there is much agreement and much evidence that all other existing alternatives do not."[30]

Previously, only one Supreme Court case, *Silverthorne Lumber Co. v. United States*,[31] has dealt directly with the applicability of the fourth amendment exclusionary rule to grand jury proceedings. Traditionally, the scope of the grand jury's powers to investigate suspected criminal activity, while not unlimited, has been extremely broad.[32] It may compel the production of evidence or the testimony of witnesses unhampered by the technical rules of procedure and evidence associated with a criminal trial.[33] The grand jury

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Bivens dissent: "I suggest that the notion that suppression of evidence in a given case effectively deters the future action of the particular policeman or of policemen generally was never more than wishful thinking on the part of the courts." Burger, *Who Will Watch the Watchman,* 14 AM. U.L. REV. 1, 12 (1964).

27. In *Elkins* Justice Stewart admitted that there was no data upon which to conclude that the exclusionary rule acts as a deterrent. Elkins v. United States, 364 U.S. 206, 218 (1960). The Court has, for the most part, simply accepted the fact that it is a deterrent without further discussion. *See, e.g.,* Terry v. Ohio, 392 U.S. 1, 12 (1968); Linkletter v. Walker, 381 U.S. 618, 636 (1965); Mapp v. Ohio, 367 U.S. 643, 656 (1961).

28. The author of perhaps the most comprehensive study to date concluded that the exclusionary rule is not an effective deterrent and that it should be abolished as soon as an alternative tort remedy can be instituted. Oaks, *Studying the Exclusionary Rule in Search and Seizure,* 37 U. CHI. L. REV. 665, 756-57 (1970).

29. Paulsen, *Safeguards in the Law of Search and Seizure,* 52 NW. U.L. REV. 65, 74 (1957).

30. Kamisar, *Wolf and Lustig Ten Years Later: Illegal State Evidence in State and Federal Courts,* 43 MINN. L. REV. 1083, 1150 (1959).

31. 251 U.S. 385 (1920).

32. For background on the grand jury process see Branzburg v. Hayes, 408 U.S. 665, 700-02 (1972); Costello v. United States, 350 U.S. 359, 361-62 (1956); Blair v. United States, 250 U.S. 273, 279-83 (1919); 1 W. HOLDSWORTH, HISTORY OF ENGLISH LAW 312-23 (7th rev. ed. 1956); 1 F. POLLOCK & F. MAITLAND, HISTORY OF ENGLISH LAW 151 (reprint 2d ed. 1923).

33. The grand jury is subject, however, to certain restraints. The grand jury must rely on the court to compel production of evidence and testimony, and the court may quash or modify a subpoena if compliance would be unreasonable or oppressive. *See* FED. R. CRIM. P. 17(c). The grand jury may not violate a valid privilege, Branzburg v. Hayes, 408 U.S. 665 (1972); United States v. Bryan, 339 U.S. 323 (1950); Blackmer v. United States, 284 U.S. 421 (1932), and may force a witness to answer self-incriminatory questions only if the witness is granted immunity coextensive with his fifth amendment privilege. Kastigar v. United States, 406 U.S. 441 (1972). Neither may it compel a person to produce private books and papers that would tend to incriminate him. Boyd v. United States, 116 U.S. 616 (1886).

proceeding is not an adversary hearing but rather is an ex parte investigation to determine whether a crime has been committed and whether criminal proceedings should be instituted against an individual. Doubts as to whether any particular person will be subject to an accusation of a crime have not limited the scope of its inquiry,[34] and as the Court recently stated, "[w]hen the grand jury is performing its investigatory function into a general problem area . . . society's interest is best served by a thorough and extensive investigation."[35] The *Silverthorne* decision, however, appears to limit rather dramatically the grand jury's investigative powers relating to evidence seized in violation of the fourth amendment. In that case, unlawfully seized documents were presented to a grand jury that had already indicted defendants. The illegal evidence was returned to defendants upon their petition to the district court. Later, the prosecutor caused the grand jury to issue subpoenas duces tecum to defendants to produce the evidence. They refused to comply and were cited for contempt. The Supreme Court reversed, holding that the subpoenas were invalid because they were based on information obtained from an unlawful seizure. The scope of *Silverthorne* was left unclear. On the one hand it seemed to indicate that a grand jury witness who is an aggrieved person has standing to challenge the sources of evidence at grand jury proceedings. On the other hand, the case's precedential value was diminished by the unique factual context in which it arose.[36] First, the seized evidence already had been ruled illegal in a prior independent proceeding. Secondly, the defendants were already under criminal indictment and thus could be said to have invoked the rule on the basis of their status as criminal defendants rather than as mere witnesses.

In the instant decision, Mr. Justice Powell speaking for the majority,[37] initially reviewed the nature and scope of the grand jury's traditional powers and concluded that the grand jury's investigative warrant must be broad if its public responsibility is to be discharged adequately. The Court noted previous decisions that manifested a disinclination to allow "litigious interference" with grand jury proceedings that would turn them into a preliminary

34. Blair v. United States, 250 U.S. 273, 282 (1919).

35. Branzburg v. Hayes, 408 U.S. 665, 700 (1972).

36. The decision also suffers from the extreme brevity of Justice Holmes's majority opinion.

37. Justice Powell was joined by Justices Stewart, White, Blackmun, Rehnquist, and Chief Justice Burger.

trial on the merits and result in protracted interruptions.[38] Turning to the exclusionary rule, the Court stated that the rule's purpose is not to redress the injury to the search victim; rather, it is a judicially created remedy designed to safeguard fourth amendment rights generally by deterring unlawful police conduct.[39] The Court then applied a balancing test to the question of the applicability of the exclusionary rule to the grand jury process.[40] It found that any deterrent effect that might accrue by application of the exclusionary rule to grand jury proceedings is "undoubtedly minimal" and "uncertain at best," reasoning that the incentive to disregard the fourth amendment solely to obtain an indictment is "substantially negated" since illegally seized evidence would be inadmissible at a subsequent trial and a prosecutor would be unlikely to seek an indictment when a conviction could not be obtained.[41] On the other hand, Justice Powell found it "evident" that this extension of the exclusionary rule would seriously impede the effective and expeditious discharge of the grand jury's duties.[42] Declaring that the derivative use of illegally obtained evidence is a question not of rights but of remedies,[43] the Court concluded that the benefit of any possible incremental deterrent effect was outweighed by the damage to the grand jury institution that would result by applying the exclusionary rule to its proceedings.[44]

Mr. Justice Brennan filed a vigorous dissent,[45] assaulting the majority's position as reflecting a "startling misconception" or "purposeful rejection" of the historical purpose and objectives of the exclusionary rule.[46] He stated that curtailment of the evil of uncon-

38. *See* United States v. Dionisio, 410 U.S. 1, 17 (1973); Gelbard v. United States, 408 U.S. 41, 69 (1972) (White, J., concurring); United States v. Ryan, 402 U.S. 530 (1971); Cobbledick v. United States, 309 U.S. 323 (1940).

39. Justice Powell in a footnote admitted that there is disagreement over the practical efficacy of the exclusionary rule and that empirical statistics are not available on its deterrent effect. He stated, however, that the instant case did not present an occasion to consider the extent of the rule's efficacy in criminal trials. 94 S. Ct. at 620 n.5.

40. "[W]e must weigh the potential injury to the historic role and functions of the grand jury against the potential henefits of the rule as applied in this context." *Id.* at 620.

41. *Id.* at 621-22.

42. The Court noted that the force of this argument was well illustrated by the facts of the instant case. Almost 2½ years had elapsed since respondent was summoned to appear and testify before the grand jury. *Id.* at 621.

43. According to the majority, the right to be free from unreasonable searches and seizures was violated at the time of the illegal search and derivative use of this evidence in grand jury proceedings worked no new fourth amendment wrong. *Id.* at 623.

44. The *Silverthorne* decision was examined by the majority in a footnote and found "certainly not controlling." *Id.* at 622 n.8. *See* note 54 *infra*.

45. Justice Brennan was joined by Justices Douglas and Marshall.

46. 94 S. Ct. at 624.

stitutional searches and seizures was, at best, only a desired effect of the exclusionary rule. The true concern of its authors, Justice Brennan reasoned, was to fashion an enforcement tool to give content and meaning to the fourth amendment guarantees and to enable the judiciary to avoid any taint of partnership in official lawlessness.[47] The dissent rejected Justice Powell's conclusion that the exclusionary rule is merely a judicially created remedy. Rather, Justice Brennan agreed with the *Mapp* Court's statement that the rule is "an essential part of both the Fourth and Fourteenth Amendments . . . ."[48] An analysis of the leading cases, primarily *Silverthorne*, which Justice Brennan characterized as "plainly controlling," convinced the dissenters that the majority's holding is "at war" with the decisions that developed the exclusionary rule and "discounts to the point of extinction" the judicial integrity doctrine.[49] Moreover, the dissent feared that the instant decision would leave a vital constitutional right without a remedy in many situations. The majority's suggestion that the grand jury witness' fourth amendment rights would be protected by the exclusion of illegally seized evidence at a subsequent criminal trial was labeled "no answer" since the witness compelled to testify might never be brought to trial. His possible remedy of damages in tort was viewed as enabling "officialdom to profit from its lawlessness if it is willing to pay a price."[50] Justice Brennan conceded that the exclusionary rule does not provide that illegally seized evidence is inadmissible against anyone for any purpose, but distinguished those individuals whose fourth amendment rights have not been violated from those whose constitutional rights have actually been abridged.[51] Finally, the dissenters feared that the instant decision signalled the first step toward abrogation of the exclusionary rule altogether in search and seizure cases, reasoning that application of the exclusionary rule at

47. *Weeks*, the decision which fashioned the rule, was quoted at length for this proposition.

48. Mapp v. Ohio, 367 U.S. 643, 651 (1961).

49. 94 S. Ct. at 626. *Silverthorne* was interpreted as holding that a grand jury must be denied access to relevant but illegally seized papers. The dissent also relied upon Gelbard v. United States, 408 U.S. 41 (1972), in which the Court was called upon to interpret § 2515 of Title III of the Omnibus Crime Control and Safe Streets Act of 1968, 18 U.S.C. §§ 2510-20 (1970). There the contempt conviction of a grand jury witness who refused to testify on the ground that interrogation was to be based upon information derived from an illegal wiretap and electronic surveillance of the witness was reversed. The statutory provision at issue, however, specifically excluded the use of this evidence in grand jury proceedings.

50. 94 S. Ct. at 628.

51. For cases dealing with the standing of an individual to move for suppression of illegally seized evidence see Alderman v. United States, 394 U.S. 165 (1969), and Jones v. United States, 362 U.S. 257 (1960).

trial could not further the goal of deterrence significantly, if its application to grand jury proceedings fails to do so.[52]

The instant decision marks a significant development in the evolution of the fourth amendment exclusionary rule. The Court clearly stated that the exclusionary rule's applicability does not extend to extra-trial proceedings when such use will not serve a significant deterrent purpose. The grand jury's historic functions—determining whether probable cause exists to believe a crime has been committed and protecting citizens against unfounded criminal prosecutions—were found to outweigh any speculative deterrent effect that might occur by imposing the exclusionary rule on grand jury proceedings. More important perhaps is the Court's characterization of the exclusionary rule as a mere judicial remedy that is not inextricably linked to, or required by, the fourth amendment. *Mapp*, however, indicated that the exclusionary rule is demanded by the fourth and fourteenth amendments.[53] This constitutional foundation, if it had been recognized in the instant decision, seemingly would have required exclusion without regard to a balancing analysis. The justification and effects of the rule should yield to its constitutional underpinnings. Ultimately these foundations would prohibit any use being made of illegally obtained evidence and would deny the courts authority to decide at what stages of the criminal process the exclusionary rule would apply once the constitutional violation is ascertained. When the rule's constitutional basis is removed and its deterrent effect undermined, there seems little justification for retaining it, and the dissent's fear that this decision may portend abrogation of the rule entirely seems well-founded. The Court's decision, moreover, fails to confront adequately several key considerations raised both in previous decisions and by the dissent. First, the majority's summary disposition in a footnote of the *Silverthorne* decision does not satisfy the precedential value that should have been accorded the case. The fact that *Silverthorne* dealt with grand jury witnesses already under indictment should not be a controlling distinction.[54] Justice Holmes was

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52. 94 S. Ct. at 628.

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

54. The majority distinguished *Silverthorne* in the following language:

There, plaintiff-in-error had previously been indicted by the grand jury and thus could invoke the exclusionary rule on the basis of their status as criminal defendants. Moreover, the Government's interest in recapturing the original documents was founded on a belief that they might be useful in the criminal prosecution already authorized by the grand jury. It did not appear that the grand jury needed the documents to perform its investigative or accusatorial functions. Thus, the primary consequence of the Court's not concerned with this fact in *Silverthorne*; instead, he apparently approached that case with exactly the same issues in mind as were raised in the instant case. If, as the majority asserts, deterrence is the major factor to be considered in applying the exclusionary rule, any distinctions between *Silverthorne* and the instant decision are rendered even more insignificant. To conclude that application of the rule in the *Silverthorne* situation would deter unlawful police conduct, but that its application in the instant factual context would not, seems little more than an arbitrary assumption. *Silverthorne* should not coexist with the instant decision but rather should have been overruled.[55] Secondly, and perhaps most important, the instant decision almost completely ignores the judicial integrity rationale, again relegating its discussion of the issue to a footnote.[56] The Court's use of a balancing approach in applying the exclusionary rule is a *de facto* abrogation of the judicial integrity doctrine since this doctrine exists independently of any deterrent considerations and the conditions necessary for its application occur at the time of the unconstitutional search and seizure. *Weeks* and *Mapp*, the leading exclusionary rule cases, placed great emphasis on the integrity doctrine,[57] which in its requirement of judicial clean hands would seem to mandate exclusion regardless of the type of proceeding. The *Weeks* Court struggled with the problem of formulating a comprehensive remedy that would vindicate the violation of fourth amendment rights. The exclusionary rule, while unable to undo the constitutional wrong previously committed, prohibited that wrong from compounding itself by finding sanction in the courts. These considerations indicate that the exclusionary rule is not only "the best we have" but that it is also the only possible sanction that will satisfy the judicial integrity rationale. An effective tort remedy for illegal search victims is unrelated to the judicial integrity doctrine. Remedies in tort have been available in some jurisdictions throughout the existence of the exclusionary rule. The possibility of a jury finding in favor of a search victim in a suit

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decision was to exclude the evidence from the subsequent criminal trial. Finally, prior to the issuance of the grand jury subpoenas, there had been a judicial determination that the search and seizure was illegal. The claim of plaintiffs-in-error was not raised for the first time in a pre-indictment motion to suppress requiring interruption of grand jury proceedings.

94 S. Ct. at 622 n.8.

55. The majority opinion noted that to the extent *Silverthorne*'s "broad dictum" might suggest a different result in the instant case, it had been "substantially undermined" by subsequent cases. 94 S. Ct. at 622 n.8.

56. 94 S. Ct. at 623 n.11.

57. See notes 14 & 15 *supra* and accompanying text.

against the police, however, has been virtually nonexistent.[58] Finally, the Court's use of the deterrence rationale itself is not satisfactory. That the exclusion of evidence will deter unlawful police conduct is yet to be proved, but even assuming that deterrence is the prime motivation for excluding illegally seized evidence, it would seem that the deterrent effect of its application should be presumed, especially with respect to pre-trial proceedings such as grand juries. The burden of proof of nondeterrence would then shift to the government.[59] The instant decision held, in effect, exactly the opposite. Indications are, however, that the exclusionary rule does not have a significant deterrent effect—police searches are made with a number of considerations in mind, with the possibility of conviction at some future date not necessarily the primary one.[60] The instant decision offered the Court an ideal opportunity to reexamine its position established in *Elkins* that deterrence is the primary reason for the rule. The Court, however, perpetuated a questionable rationale for a vital constitutional doctrine. This weak foundation could indeed bring the entire exclusionary rule down if and when it is shown that deterrence is not a significant effect of the rule when applied at trial. Viewed in the context of other recent decisions of the Court regarding search and seizure,[61] the instant decision is not surprising. The full extent of the present Court's willingness to reverse the Warren Court's stance on illegal searches remains to be seen. The groundwork has been laid, however, for

58. Criminal sanctions also have been provided in some jurisdictions, but the hesitancy of a jury to convict and of a prosecutor to bring charges has made a criminal remedy (which would, of course, truly serve a deterrent purpose) one in theory only. *See* Oaks, *supra* note 12, at 673.

59. In Gelbard v. United States, 408 U.S. 41 (1972), the Court set aside the contempt citation of a grand jury witness who refused to testify on the ground that interrogation was to be based on information obtained from illegal wiretapping and electronic surveillance. The decision upheld tbe literal language of 18 U.S.C. § 2515 (1970), which provides specifically for exclusion of such evidence from grand jury proceedings. This congressional application of the exclusionary rule to grand jury proceedings seems to vitiate the majority's fears of litigious interference with the grand jury process since Congress obviously was willing to sacrifice the possibility of an indictment and ultimate conviction to protect a grand jury witness' right to privacy. The majority felt that reliance upon *Gelbard* was "misplaced" since the statute "represented a congressional effort to afford special safeguards against the unique problems posed by misuse of wiretapping and electronic surveillance." 94 S. Ct. at 623 n.11.

60. *See* Oaks, *supra* note 12, at 706-57.

61. *See, e.g.*, United States v. Robinson, 94 S. Ct. 467 (1973) (full search allowed when traffic offender placed under custodial arrest); Gustafson v. Florida, 94 S. Ct. 488 (1973) (same); United States v. Dionisio, 410 U.S. 1 (1973) (no warrant required to take scrapings from under fingernails of murder suspect, although suspect was not under arrest, had gone to the police station voluntarily, and had not consented to the search).

dramatic future developments by Congress[62] or the Court.[63]

Securities Regulation—Rule 10b-5—Plaintiffs Who Are Neither Purchasers nor Sellers of Securities May Recover Under Rule 10b-5 if Injured in Their Capacity as Investors as a Direct Consequence of Fraud in Connection with a Securities Transaction

Defendant Dave Waite Pontiac, Inc., sold its automobile leasing business to Bank Service Corporation, in which plaintiffs were shareholders, in exchange for Bank Service stock. As additional consideration for the sale, plaintiffs guaranteed certain notes, payable to defendant General Motors Acceptance Corporation, which Bank Service had assumed.[1] When the leasing business failed and Bank Service defaulted on the notes, GMAC sued plaintiffs in state court to recover on the guarantees. Claiming that the value of the assets had been misrepresented and seeking rescission of the guarantees, plaintiffs then filed suit in federal court alleging fraud in connection with the sale of securities in violation of section 10(b) of the Securities Exchange Act of 1934[2] and Rule 10b-5.[3] Defendants

62. *See* note 25 *supra*. The constitutionality of the proposed legislation now is virtually certain.

63. One apparent consequence of the Burger Court's turnabout regarding search and seizure cases has been a reduction in the number of cases appealed to the Supreme Court. Defense attorneys fear that the Court may overrule a decision of the Warren years. Wall Street J., Feb. 14, 1974, at 1, col. 1.

1. Bank Service assumed the liabilities of the business, which included loans by GMAC to finance automobile purchases. Plaintiffs guaranteed future liabilities as well as the notes.

2. Section 10, 15 U.S.C. § 78j (1970) provides in part:

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

3. Rule 10b-5, 17 C.F.R. § 240.10b-5 (1973) provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interestate [*sic*] commerce, or of the mails or of any facility of a national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,

contended that since plaintiffs had not purchased or sold securities, they lacked standing to sue under Rule 10b-5.[4] The district court dismissed plaintiffs' complaint. On appeal to the United States Court of Appeals for the Seventh Circuit, *held*, reversed and remanded. Plaintiffs who are not buyers or sellers of securities may obtain relief under Rule 10b-5 if they are injured in their capacity as investors as a direct result of fraud in connection with the purchase or sale of securities. *Eason v. General Motors Acceptance Corp.*, 490 F.2d 654 (7th Cir. 1973), *petition for cert. filed*, 42 U.S.L.W. 3511 (U.S. Feb. 28, 1974) (No. 73-1323).

Section 10(b) of the Securities Exchange Act of 1934 authorizes the SEC to make rules prohibiting fraud in connection with sales or purchases of securities, "in the public interest or for the protection of investors."[5] To provide prohibitions against fraud by purchasers of securities similar to those against fraud by sellers found in section 17(a) of the Securities Act of 1933,[6] the SEC adopted Rule 10b-5 in 1942.[7] Although neither section 10(b) nor Rule 10b-5 explicitly provides for it, a private right of action under the Rule has been implied uniformly since a 1946 case, *Kardon v. National Gypsum Co.*,[8] and was confirmed by the Supreme Court in 1971.[9] The basis for this implied right, as explained in *Kardon*, is the principle of tort

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(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

4. Plaintiffs argued that they were purchasers or sellers of a security by virtue of their delivery of tbe guarantees, their effective "forced purchase" of the notes on default, or the issue of tbe stock by Bank Service to defendants. They further urged the court to abandon the purchaser-seller requirement for standing under Rule 10b-5.

5. 15 U.S.C. § 78j (1970).

6. Section 17(a), 15 U.S.C. § 77q (1970) provides:

It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

The language of Rule 10b-5 follows this section closely. *See* note 3 *supra*.

7. SEC Securities Exchange Act Release No. 3230 (May 21, 1942); *see* 1 A. BROMBERG, SECURITIES LAW: FRAUD—SEC RULE 10b-5 § 2.2 (420) (1973).

8. 69 F. Supp. 512 (E.D. Pa. 1946).

9. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.9 (1971).

law that a violation of a statute creates a right of action in persons injured if the intent of the statute is to protect both the class to which the plaintiff belongs and the interest that has been invaded.[10] In attempting to impose some limits upon the scope of Rule 10b-5 as a basis for a private right of action, courts have applied concepts of reliance,[11] causation,[12] scienter,[13] and privity[14] derived from the common-law tort action of deceit.[15] With the elimination of the requirement that the defendant be a purchaser or seller of securities,[16] however, and the uncertainty surrounding reliance and scienter as elements of the 10b-5 cause of action,[17] the Rule has undergone a dramatic expansion.[18] Although the Supreme Court has stated that the Rule should be construed flexibly in order to accomplish its purpose of protecting investors from fraud,[19] the doctrine that plaintiff must be a purchaser or seller of securities, first stated in *Birnbaum v. Newport Steel Corp.*,[20] nevertheless has remained as a persistent limitation to actions under Rule 10b-5. In *Birnbaum*, the Second Circuit looked to the administrative history of the Rule and reasoned that it was intended to reach only the types of fraud

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10. *See* RESTATEMENT (SECOND) OF TORTS § 286 (1965):

> The court may adopt as the standard of conduct of a reasonable man the requirements of a legislative enactment or an administrative regulation whose purpose is found to be exclusively or in part
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> (a) to protect a class of persons which includes the one whose interest is invaded, and
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> (b) to protect the particular interest which is invaded, and
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> (c) to protect that interest against the kind of harm which has resulted, and
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> (d) to protect that interest against the particular hazard from which the harm results.

11. *E.g.*, List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

12. *E.g.*, Barnett v. Anaconda Co., 238 F. Supp. 766, 776 (S.D.N.Y. 1965).

13. *E.g.*, Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971).

14. *E.g.*, Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701, 706 (S.D.N.Y. 1951).

15. *See* 2 A. BROMBERG, *supra* note 7, at §§ 8.1-.9; 3 L. LOSS, SECURITIES REGULATION 1763-70 (1961).

16. Heit v. Weitzen, 402 F.2d 909 (2d Cir. 1968).

17. *See* 2 A. BROMBERG, *supra* note 7, at §§ 8.4, 8.6, 8.9; Epstein, *The Scienter Requirement in Actions Under Rule 10b-5*, 48 N.C.L. REV. 482 (1970); Note, *The Nature and Scope of the Reliance Requirement in Private Actions under SEC Rule 10b-5*, 24 CASE W. RES. L. REV. 363 (1973).

18. "In recent years, the rule has been applied in such a variety of situations that one can scarcely find an issue of the advance sheets of the Federal Supplement and Federal Reporter that does not contain an opinion on § 10(b)." Rekant v. Desser, 425 F.2d 872, 877 (5th Cir. 1970).

19. "Section 10(b) must be read flexibly, not technically and restrictively." Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971).

20. 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952).

normally associated with sales or purchases of securities (the "first branch") and that it "extended protection only to the defrauded purchaser or seller" (the "second branch"). While the first branch has since been discredited,[21] the second branch is well established, and is now usually characterized as a "standing" requirement.[22] Some courts, like the Fifth Circuit in *Herpich v. Wallace*,[23] have regarded the requirement as a constitutional and jurisdictional necessity on the theory that only plaintiffs who assert interests arguably within the zone of interests to be protected by a statute have standing under the Constitution.[24] Others have upheld the standing requirement on the ground that such a well-established interpretation should be altered only by Congress,[25] or that it is necessary to restrict the expansion of federal corporate law into areas better left to the states,[26] or to prevent a flood of litigation based on unproveable allegations.[27] The courts have modified the doctrine, however, by creating numerous exceptions and by giving the requirement an extremely flexible interpretation. For example, persons with an unconsummated contract to buy or sell,[28] minority shareholders in short-form mergers,[29] issuers of securities,[30] merging corporations,[31]

21. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971).

22. *See, e.g., id.* at 13 n.10; Landy v. FDIC, 486 F.2d 139, 156 (3d Cir. 1973); Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 798 (2d Cir. 1969).

23. 430 F.2d 792 (5th Cir. 1970).

24. *But see* H.K. Porter, Inc. v. Nicholson File Co., 353 F. Supp. 153, 166 (D.R.I. 1972), *aff'd*, 482 F.2d 421 (1st Cir. 1973). The Fifth Circuit applied the 2-part standard used by the Supreme Court in Association of Data Processing Serv. Organizations, Inc. v. Camp, 397 U.S. 150, 152-53 (1970) ("whether the plaintiff alleges that the challenged action has caused him injury in fact" and "whether the interest sought to be protected by the complainant is arguably within the zone of interests to be protected or regulated by the statute or constitutional guarantee in question."). It found that only purchasers or sellers could satisfy the second requirement, characterizing Rule 10b-5 as protecting only the right to buy or sell without fraud. For a discussion of standing in tbe general constitutional context see Davis, *The Liberalized Law of Standing*, 37 U. CHI. L. REV. 450 (1970).

25. Landy v. FDIC, 486 F.2d 139, 156-57 (3d Cir. 1973); Mount Clemens Indus., Inc. v. Bell, 464 F.2d 339, 343 (9th Cir. 1972); Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963, 969 (2d Cir. 1969).

26. Simmons v. Wolfson, 428 F.2d 455, 456-57 (6th Cir. 1970); Iroquois Indus., Inc. v. Syracuse China Corp., 417 F.2d 963, 969 (2d Cir. 1969).

27. Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136, 147 (9th Cir. 1973) (dissenting opinion).

28. *See* Opper v. Hancock Sec. Corp., 367 F.2d 157 (2d Cir. 1966); Goodman v. Hentz & Co., 265 F. Supp. 440 (N.D. Ill. 1967); Note, *Inroads on the Necessity for a Consummated Purchase or Sale Under Rule 10b-5*, 1969 DUKE L.J. 349. *Contra*, Keers & Co. v. American Steel & Pump Corp., 234 F. Supp. 201 (S.D.N.Y. 1964). The contract exception can be justified by the language of § 3(a) of the 1934 Act, which expressly includes contracts to buy and sell within the definitions of tbe terms "buy" and "sell". 15 U.S.C. §§ 78c(a)(13), (14) (1970).

29. Vine v. Beneficial Fin. Co., 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967).

personal representatives of purchasers and sellers,[32] and beneficiaries of trusts whose trustees buy or sell[33] have all been permitted to sue under Rule 10b-5. Similarly, under a flexible reading of the requirement, a plaintiff who is dissuaded fraudulently from entering into a transaction,but who eventually does buy or sell, may have standing through the later transaction.[34] The Second Circuit further limited the applicability of the purchaser-seller requirement in *Mutual Shares Corp. v. Genesco*,[35] holding that it did not apply to suits for injunctive relief. The court's reasoning rested on the premise that the *Birnbaum* rule is primarily a means to ensure that plaintiff can prove damages and causation. According to the Second Circuit, plaintiffs who are not purchasers or sellers cannot prove a loss causally related to a purchase or sale, and therefore cannot recover damages; however, this inability does not bar a suit for injunctive relief because such suits do not require proof of damages. Although the court in *Mutual Shares* limited its holding to prospective injunctive relief and seemed to reaffirm *Birnbaum* in damage actions, that opinion is the source of the reasoning in two district court cases that expressly disavow the purchaser-seller requirement. In *Tully v. Mott Supermarkets, Inc.*,[36] the New Jersey district court granted retrospective injunctive relief, in the form of rescission of an election of corporate directors, to plaintiffs who were neither buyers nor sellers of securities. The court stated that it declined to

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Such plaintiffs are characterized as "forced sellers" since they will eventually be forced to convert their shares into either cash or stock in the surviving corporation.

30. *E.g.*, Hooper v. Mountain States Sec. Corp., 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961).

31. *E.g.*, Dasho v. Susquehanna Corp., 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967). This is based on the reasoning that the exchange of stock of one corporation for that of another pursuant to a merger should be given the same protection as an ordinary exchange of securities for cash. *See generally* 26 VAND. L. REV. 887 (1973).

32. *E.g.*, Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6 (1971) (state insurance commissioner representing insurance company); Nanfito v. Tekseed Hybrid Co., 341 F. Supp. 234 (D. Neb. 1972) (administrator of estate representing decedent).

33. James v. Gerber Prod. Co., 483 F.2d 944 (6th Cir. 1973); Heyman v. Heyman, 356 F. Supp. 958 (S.D.N.Y. 1973). The courts in these 2 cases reasoned that the beneficiary is the person whose interests are at stake in the transaction, and therefore the policies expressed in *Birnbaum* are not violated by granting him standing.

34. *E.g.*, Crane v. Westinghouse Air Brake Co., 419 F.2d 789 (2d Cir. 1969); Travis v. Anthes Imperial Ltd., 331 F. Supp. 797 (E.D. Mo. 1971); Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965). *Contra*, Hirsch v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 311 F. Supp. 1283 (S.D.N.Y. 1970). These cases refer to plaintiffs as "forced sellers," but the term "delayed sellers" is more accurate.

35. 384 F.2d 540 (2d Cir. 1967).

36. 337 F. Supp. 834 (D.N.J. 1972).

follow *Birnbaum*[37] because it found no such purchaser-seller requirement in the language of section 10(b) or Rule 10b-5 and because of the trend to read the Rule broadly. In *Young v. Seaboard Corp.*,[38] the Utah district court went further, giving standing to shareholders of an insolvent bank to sue the management for damages. Stating that the problem of proof should be left to the general law of damages, the court suggested that all plaintiffs who can show "a direct and causal relationship between . . . fraud and the claimed injury"[39] should have the right to sue for damages as well as injunctive relief. In addition to these two district courts, several other courts have questioned the *Birnbaum* rule, but their comments have thus far been confined to dicta.[40] The SEC now also advocates its abandonment.[41] Despite these indications of a trend away from the purchaser-seller requirement, all but the Fourth and Seventh Circuits have adopted it,[42] and the Supreme Court has never considered the issue.[43] While *Dasho v. Susquehanna Corp.*[44] has often been cited as adopting the requirement in the Seventh Circuit,[45] that court actually avoided ruling on the validity of the purchaser-seller requirement by holding that the plaintiff, a merging corporation, was a purchaser or seller. Thus, before the instant case, no court of appeals had yet disavowed *Birnbaum*, although its status in the Seventh Circuit was in doubt.

The instant court initially observed that defendants' alleged conduct was undoubtedly a violation of Rule 10b-5, for which Bank Service could have recovered damages. Assuming that plaintiffs could not be characterized as purchasers or sellers of securities, the

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37. *Id.* at 839.

38. 360 F. Supp. 490 (D. Utah 1973).

39. *Id.* at 495.

40. *See* Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir. 1973); Competitive Associates, Inc. v. International Health Sciences, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,632, at 92,870 (S.D.N.Y. 1972); Fabrikant v. Jacobellis, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,686, at 99,017 (E.D.N.Y. 1970).

41. In several recent cases challenging *Birnbaum*, the SEC has filed *amicus curiae* briefs for tbe plaintiff. *See, e.g.*, Mount Clemens Indus., Inc. v. Bell, 464 F.2d 339, 341 (9th Cir. 1972).

42. H.K. Porter Co. v. Nicholson File Co., 482 F.2d 421 (1st Cir. 1973); Landy v. FDIC, 486 F.2d 139 (3d Cir. 1973); Vincent v. Moench, 473 F.2d 430, 433 (10th Cir. 1973); Mount Clemens Indus., Inc. v. Bell, 464 F.2d 339 (9th Cir. 1972); Herpich v. Wallace, 430 F.2d 792 (5th Cir. 1970); Simmons v. Wolfson, 428 F.2d 455 (6th Cir. 1970), *cert. denied*, 400 U.S. 999 (1971); City Nat'l Bank v. Vanderboom, 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970). The Fourth Circuit has apparently never been forced to face the issue.

43. *See* Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 n.10 (1971).

44. 380 F.2d 262 (7th Cir.), *cert. denied*, 389 U.S. 977 (1967).

45. Landy v. FDIC, 486 F.2d 139, 156 n.11 (3d Cir. 1973); Mount Clemens Indus., Inc. v. Bell, 464 F.2d 339, 342 n.5 (9tb Cir. 1972).

court then reassessed the validity of the *Birnbaum* requirement in order to determine their right to relief. It first distinguished this requirement from that of standing in the constitutional sense, which it interpreted as requiring only a sufficient interest in an actual dispute to satisfy the article III case or controversy standard.[46] It decided that plaintiffs clearly had an interest sufficient to satisfy this requirement. The court then reasoned that plaintiffs, although not purchasers or sellers, nevertheless belonged to the class for whose benefit Rule 10b-5 was adopted. It found that by creating exceptions and modifications to the strict *Birnbaum* holding, the courts have recognized tacitly that this protected class includes more than just purchasers and sellers. Furthermore, the policy favoring a broad construction of Rule 10b-5 was found to be inconsistent with such a rigid delineation of the class. Having concluded that the protected class includes more than just purchasers and sellers, the court then examined and rejected policy arguments offered to justify the purchaser-seller requirement. It regarded the desire to avoid an increase in the judicial workload as an invalid reason for denying relief to an injured plaintiff, and doubted that the demise of *Birnbaum* would necessarily cause such an increase. It also rejected the argument that *Birnbaum* should be followed to maintain consistency among the federal courts of appeals, stating that conflicts may be resolved by the Supreme Court. Considering the language of section 10(b), Rule 10b-5, and recent Supreme Court opinions,[47] the instant court concluded that the class protected by the Rule included all "persons who, in their capacity as investors, suffer significant injury as a direct consequence of fraud in connection with a securities transaction."[48] Applying this analysis to the facts of the instant case, the court reasoned that the plaintiffs were "investors" in the transaction since they were stockholders of Bank Service, and that they were direct parties to the transaction since they guaranteed the loans. It concluded that plaintiffs, as investors and as principals in a fraudulent transaction, had standing to sue under 10b-5.

As the first court of appeals to reject the *Birnbaum* doctrine, the instant court may begin a trend that will eliminate the purchaser-seller requirement in suits under Rule 10b-5. This result has been both predicted and advocated by many commentators,[49]

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

47. The court cited Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12-13 (1971).

48. 490 F.2d at 659.

49. *E.g.*, Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5,*

and there is nothing in the language of section 10(b) or Rule 10b-5 to preclude it. On the contrary, it would effectuate their purposes more fully by increasing private enforcement. Additionally, the present rule, with its numerous exceptions and qualifications, frequently produced illogical results. For example, under the *Birnbaum* doctrine, an investor who calls his broker, tells him to sell a certain security, and then is dissuaded from selling by the broker's misrepresentations, has no standing to sue under Rule 10b-5; yet if he sells the same stock six months later, he may, as a seller, have standing to recover damages for fraud in the previous uncompleted transaction.[50] Standing in this situation is thus made to turn on a fortuitous event occurring long after the violation of Rule 10b-5. Several policy arguments have been advanced to justify the *Birnbaum* requirement despite such arbitrary results. Although it has been defended as a means of restraining the expansion of the federal law of corporations into fields already covered by state law, the requirement that plaintiff be a purchaser or seller bears no relation to the presence or absence of state remedies, and is therefore an inappropriate expression of that policy. That the SEC did not envisage the broad scope of the Rule when it was originally promulgated is, in itself, an inadequate reason for continuing to apply the *Birnbaum* requirement, especially since the SEC now advocates its abandonment. The desire to eliminate spurious claims by use of an arbitrary rule that also denies recovery to persons with valid claims is not a legitimate consideration, since the function of the court should be to decide in each case whether the proof is sufficient to permit recovery. This leaves the desire to limit potential liability under Rule 10b-5 as a reason for retention of the *Birnbaum* rule. In cases of fraud relating to securities traded on the national exchanges, the number of potential plaintiffs who might claim damages is tremendous even under the *Birnbaum* rule. The courts' reluctance to expand further the scope of Rule 10b-5 is therefore understandable. The additional liability, however, will have little effect on a defendant who already is bankrupted by his present liability. Furthermore, it would be more appropriate to limit 10b-5 liability by strengthening the substantive requirements of the cause

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54 VA. L. REV. 268 (1968); Ruder, *Current Developments in the Federal Law of Corporate Fiduciary Relations—Standing to Sue Under Rule 10b-5*, 26 BUS. LAW. 1289 (1971); Note, *Inroads on the Necessity for a Consummated Purchase or Sale Under Rule 10b-5*, 1969 DUKE L.J. 349; Note, *10b-5 Standing Under Birnbaum: The Case of the Missing Remedy*, 24 HASTINGS L.J. 1007 (1973).

50. *Compare* Stockwell v. Reynolds & Co., 252 F. Supp. 215 (S.D.N.Y. 1965), *with* Morrow v. Schapiro, 334 F. Supp. 399 (E.D. Mo. 1971).

of action, since the purchaser-seller requirement bears little relationship to the policies of the Rule. Nevertheless, those circuits that embraced the *Birnbaum* requirement enthusiastically only a few years ago are unlikely to reverse themselves in the immediate future. Even if the instant decision is not followed in other circuits, however, it does create a conflict that may force the Supreme Court to decide the issue at last. In view of its policy of liberal interpretation of Rule 10b-5, the Court, when finally faced with the question, is unlikely to uphold the *Birnbaum* doctrine.[51] If the purchaser-seller requirement is abandoned, the courts then must decide what criterion to use in its place. They can, like the district courts in *Tully* and *Young*, permit recovery by anyone who can prove damages and causation, or they can impose a further limitation on the class of possible plaintiffs, such as that adopted by the instant court. Although the court states that it refuses to formulate a succinct substitute for *Birnbaum* and prefers to permit the process of case-by-case adjudication to define the limits of 10b-5 liability,[52] the court in effect has defined the class of plaintiffs with standing as "persons who, in their capacity as investors, suffer significant injury as a direct consequence of fraud."[53] Thus, the instant case seems to represent a middle ground between *Birnbaum* and the elimination of all 10b-5 standing requirements. This fact may make it more acceptable to those courts that fear a detrimental effect on the securities markets from expanded potential liability. Yet if the instant characterization is to be used as the criterion for standing to sue, it raises two questions: who is an "investor," and what is a "direct consequence"? The court's analysis of the facts in the instant case indicates that stockholders in a corporation that buys or sells securities qualify as investors. In many cases in which the *Birnbaum* rule is applied, plaintiffs are stockholders whose stock has lost value through fraud in a securities transaction by the corporation. If such injury is construed as a direct consequence of the fraud, the instant decision suggests that they will be able to sue in their individual capacities as well as derivatively. Another type of

51. The ALI neither codifies nor rejects the *Birnbaum* doctrine in the proposed Federal Securities Code, but rather leaves the area to the courts for further development. In § 1423, it permits a court to recognize civil liabilities beyond those specified in the code if, among other things, the prohibition which has been violated "is intended to protect a class of persons to which the plaintiff belongs against the kind of harm alleged." ALI FED. SECURITIES CODE § 1423, Comment (5) at 186 (Tent. Draft No. 2, 1973). It thus seems to authorize the approach taken by the instant court.

52. 490 F.2d at 660 n.29.

53. 490 F.2d at 659.

factual situation in which the instant court's analysis can make a significant difference is that of a plaintiff who fraudulently is dissuaded from selling securities. While under *Birnbaum* his right to recover depends on whether he later sold the securities at a loss, he seems to have been injured as a direct consequence of the fraud and in his capacity as an investor. Since his investment decision has been distorted by fraud, he should be within the class the Rule was intended to protect, and should have standing to sue under the logic of the instant decision.[54] A similar analysis can be made for a plaintiff who intended to buy but fraudulently was induced not to purchase. The two cases differ, however, since the class of potential sellers is limited to shareholders, while the class of potential buyers is unlimited.[55] Theoretically, in the case of a security traded on a national exchange, anyone could allege that he would have bought had he not read a misleading press release, for example. Fear of this type of suit may be a justifiably significant factor in the courts' reluctance to discard the *Birnbaum* rule; yet the instant court's criteria for standing to sue do not appear to solve this problem. Nevertheless, the court seems justified in relying on the general law of damages to eliminate such suits because few such plaintiffs will have proof that they would actually have bought. Since the standard to be used in place of the *Birnbaum* rule is not entirely clear from the instant case, it is also possible that a case-by-case development may result in a much broader or narrower class of plaintiffs. If the issue is expressed as whether the specific plaintiff in each case is within the class protected by the Rule, and the two-part criterion stated in the instant case is not applied, the results are much less predictable, since the standard in effect will depend on each court's version of the policy of the Rule. Such a flexible standard will permit courts to respond to the equities of individual cases but is likely to create inconsistent results. A lack of clarity in the substantive criteria of a 10b-5 violation would be unfair to potential defendants attempting to plan their conduct and therefore jurisprudentially suspect. Uncertainty in the standing rule, however, is unfair only if it is assumed that a potential defendant is entitled to weigh the penalty in planning an illegal act. Surely this is an assumption that

54. The proposed Federal Securities Code recognizes a deceptive act inducing someone to hold, as well as to sell, a security as a violation of the securities laws, but leaves the question of a private right to sue to the discretion of the courts. ALI FED. SECURITIES CODE § 1301, Comment (2)(b) at 33, § 1402, Comment (3) at 79 (Tent. Draft No. 2, 1973).

55. The proposed Federal Securities Code differentiates between fraud inducing one to hold a security and fraud inducing one not to buy, recognizing the former as a violation without mentioning the latter. *See* note 54 *supra*.

few courts would be disposed to make. Thus, fairness to potential defendants is not a compelling argument for adherence to the rigid certainty of the *Birnbaum* rule. Despite the uncertainty in its standard and the likelihood that it will produce a further expansion of 10b-5 liability, the standing rule adopted by the instant court is still preferable to the present purchaser-seller requirement and its numerous exceptions.

Securities Regulation—Stock Exchanges—Good Faith Discretionary Action by a Stock Exchange to Rescue a Broker-Dealer Is a Defense to an Action for Nonenforcement of Stock Exchange Rules Under Section 6 of the Securities Exchange Act of 1934.

Plaintiff brought suit[1] against defendant, New York Stock Exchange,[2] a registered national securities exchange, for a loss suffered when his securities were liquidated pursuant to a subordination agreement;[3] he alleged violation of section 6[4] of the Securities Exchange Act of 1934,[5] claiming that the failure to suspend the broker-

1. Plaintiff sought $1,400,000 in compensatory damages, $250,000 in punitive damages and interest at the rate of 7%.

2. Plaintiff also brought suit against the broker-dealer, Dempsey-Tegeler & Co., Inc., and 2 of its executives.

3. Under the terms of the subordination agreement, plaintiff transferred $1,271,600 worth of securities to the broker-dealer's capital account. The transfer had the effect of subjecting the securities to possible claims of creditors. In return, plaintiff was paid interest on the value of his securities at the rate of one-half of 1% above the prime rate and was allowed to continue receiving all interest, dividends, and distributions on the securities.

4. Section 6(b), 15 U.S.C. § 78f(b) (1970) states:

> No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a memher for conduct or proceeding inconsistent witb just and equitable principles of trade, and declare that the willful violation of any provisions of this title or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade.

Section 6(d), 15 U.S.C. § 78f(d) (1970) states:

> If it appears to the Commission that the exchange applying for registration is so organized as to be able to comply with the provisions of this title and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange.

5. The plaintiff also sought recovery against the Exchange for violation of 1) the antifraud provisions of § 10(h) of the Securities Exchange Act, 15 U.S.C. § 78j (1970); § 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l (1970); and § 17 of the Securities Act, 15 U.S.C.

dealer with whom he had placed his securities was a breach of the Exchange's duty to enforce its rules. The broker-dealer had experienced extreme financial difficulty, had violated Exchange rules pertaining to net capital requirements[6] and the maintenance of adequate books and records,[7] and was unable to comply fully with an Exchange order to centralize its operations and reorder its accounting system. The Exchange did not suspend the broker-dealer, but sanctioned its management,[8] restricted its operations,[9] and made a discretionary interpretation of its net capital rule[10] to give the broker-dealer capital credit for unregistered stock. The firm later experienced further net capital deficiencies and the Exchange encouraged and approved the subordination agreement between plaintiff and the broker-dealer.[11] Shortly thereafter, a general market decline forced both the sale of plaintiff's securities pursuant to the agreement and the liquidation of the broker-dealer.[12] Plaintiff contended that the Exchange, in not suspending the broker-dealer, had failed to enforce its rules[13] and thereby violated section 6 of the 1934

§ 77q (1970), 2) the duty of a "controlling person" under § 15 of the Securities Act, 15 U.S.C. § 77o (1970) and § 20(a) of the Securities Exchange Act, 15 U.S.C. § 78t (1970), 3) the general duty of a fiduciary at common law, and 4) the general tort-law duty, the breach of which makes one an aider and abettor to a principal tortfeasor at common law.

6. N.Y.S.E. Rule 325 establishes net capital requirements for Exchange memhers which require that "[n]o member . . . shall permit, in the ordinary course of business as a broker, . . . its Aggregate Indebtedness to exceed 2000 per centum of . . . its Net Capital. . . ." CCH NYSE GUIDE ¶ 2325, at 3525. The purpose of the rule is to prevent brokers from continuing operations unless they have the requisite cash or liquid assets in the required ratio to liquid assets.

7. N.Y.S.E. Rules 342 and 440 require the exercise of appropriate supervisory control and the maintenance of adequate books and records so as to insure a source of information fairly reflecting the financial and operational status of the firm for customers, investors and the general public. CCH NYSE GUIDE ¶¶ 2342, 2440, at 3585, 3781.

8. The firm was fined $100,000, its president $50,000, and a senior vice-president $5,000.

9. The Exchange prohibited the broker-dealer from advertising and adding registered representatives. It also limited the maximum number of weekly trades and required an immediate infusion of new capital.

10. *See* rule cited note 6 *supra*.

11. In addition to the subordination agreement with plaintiff, the broker-dealer obtained an additional $7,000,000 subordinated loan from another individual secured by King Resources stock having a value of $10,000,000. Even giving capital credit for these securities, however, the broker-dealer still had a net capital deficiency of $10,241,000 on March 24, 1970—the date on which plaintiff subordinated his securites.

12. By July 1970 the value of the shares of King Resources had dropped from $23 per share to $1.50 per share. This decline coupled with a general market decline was disastrous for the broker-dealer in that it not only reduced the value of its net capital position but also inhibited its ability to obtain new financing as well as to maintain existing financing. Moreover, there was a general decline in trading volume that aggravated the broker's financial difficulties.

13. N.Y.S.E Rule 345 provides that disciplinary proceedings may be taken against member firms who violate Exchange rules. CCH NYSE GUIDE ¶ 2345, at 3590-91. N.Y.S.E.

Act. Defendant, pointing to plaintiff's knowledge of both the risks involved and the broker-dealer's chances for recovery at the time he entered into the agreement, argued that its own actions amounted to a good faith attempt to rescue the broker-dealer from financial collapse in order to protect the broker-dealer's creditors and to prevent a general market loss of confidence that would adversely affect other firms within the Exchange's responsibility. It therefore maintained that the actions taken were within its discretion and did not constitute a breach of its duty under section 6. The United States District Court for the Central District of California, *held*, judgment for defendant. Action short of suspension taken by a registered national securities exchange as part of a good faith effort to rescue a broker-dealer from extreme financial difficulty and to prevent a general market loss of confidence is within the discretion of the exchange and does not constitute a violation of its rule-enforcement duty under section 6 of the Securities Exchange Act of 1934. *Hughes v. Dempsey-Tegeler & Co., Inc.*, ___ F. Supp. ___, CCH FED. SEC. L. REP. ¶ 94,133, at 94,525 (C.D. Cal. Sept. 4, 1973).

The Securities Exchange Act of 1934 requires the registration of all national securities exchanges.[14] Section 6 of the Act provides that an exchange may register by filing with the Securities and Exchange Commission (SEC) a registration statement containing an agreement to comply with and to enforce its members' compli-

CONST. art. XIII, § 2 provides that whenever it should appear to the Exchange that a member "has failed to meet his engagements or is insolvent, or . . . in such financial or operating condition that he cannot be permitted to continue in business with safety to his creditors . . . such member shall thereby become suspended from membership . . . ." CCH NYSE GUIDE ¶ 1602, at 1084. N.Y.S.E. CONST. art. XIV, § 6 provides that after determining that a member was in violation of the Exchange constitution or of any rule promulgated thereunder, or that a member has engaged in conduct inconsistent with just and equitable principles of trade, the Exchange may suspend that memher. CCH NYSE GUIDE ¶ 1656, at 1086. N.Y.S.E. CONST. art XIV, § 14 provides for disciplinary proceedings against member firms in instances of violative conduct except that such proceedings are not required when a memher has entered into a consent penalty with the Exchange. CCH NYSE GUIDE ¶ 1664, at 1088-89. N.Y.S.E. CONST. art. XIV, § 13 allows the Exchange to "remit or reduce" penalties, "[i]n any proceeding in which the Board of Governors may impose the penalty of suspension or expulsion . . . ." CCH NYSE GUIDE ¶ 1663, at 1087-88. From the above rules it is not clear whether either mandatory suspension under Article XIII, § 2 or discretionary suspension under Article XIV, § 6 was appropriate in the instant case in light of Article XIV, § 14, which suspends the requirement of disciplinary proceedings once consent penalties have been entered into. At least one writer, however, has said that Articles XIII, § 2 and XIV, § 6 mandate preliminary enforcement procedures that must be followed for the Exchange to be acting within the houndaries of its permitted discretion. Further, it is argued that the Exchange's ability to remit or reduce penalties can not be invoked until such procedures have been followed and suspension initially imposed. *See* Note, *Exchange Liability for Net Capital Enforcement*, 73 COLUM. L. REV. 1262, 1284-85 (1973).

14. 15 U.S.C. § 78e (1970).

ance with the provisions of the 1934 Act and any rule or regulation made thereunder.[15] Section 6(b) states that registration shall not be granted unless the rules of an exchange provide for the expulsion, suspension, or discipline of a member for conduct inconsistent with just and equitable principles of trade.[16] Section 6(d) empowers the SEC to register an exchange upon a finding that the exchange's organization enables it to comply with the provisions of the 1934 Act and the rules and regulations thereunder and that the rules of the exchange are just and adequate to insure fair dealing and to protect customers.[17] While no express private right of action is granted under section 6, the courts have construed it to grant an implied private right of action against an exchange for failure to enforce its rules. The Second Circuit, in the 1944 case of *Baird v. Franklin*,[18] first granted this private right of action when the New York Stock Exchange was sued for failure to enforce its rules and to take disciplinary action against a member who the Exchange had reason to believe had converted plaintiff's securities. The majority found that the 1934 Act placed a broad duty upon an exchange[19] to enforce its rules, to investigate the dealings and financial conditions of its members, and to suspend or expel members who it had reason to believe had been guilty of conduct inconsistent with just and equitable principles of trade. The rationale behind this duty is expressed in Judge Clark's separate opinion.[20] He reasoned that the Exchange rules required under section 6(b) must be read together with the purposes expressed in section 6(d) of insuring fair dealing and protecting investors.[21] These purposes could be realized only if section 6(b) were construed to impose the twofold duty upon an exchange of both enacting and enforcing its rules.[22] He then stated that a

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15. 15 U.S.C. § 78f (1970).

16. 15 U.S.C. § 78f(b) (1970). *See* text of statute cited note 4 *supra*.

17. 15 U.S.C. § 78f(d) (1970). *See* text of statute cited note 4 *supra*.

18. 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944).

19. The majority in summary fashion adopted the view developed in Judge Clark's dissenting opinion that § 6 imposed a duty upon an exchange to enforce its rules in stating:

> We accede to the view that the Stock Exchange violated a duty when it failed to take disciplinary action against Richard Whitney on November 24, 1937, after there was reason to believe that the latter had converted plaintiffs' securities.

141 F.2d at 239.

20. 141 F.2d 238, 240. While Judge Clark concurred with the majority as to the Exchange's duty to enforce its rules, he dissented from the majority's conclusion that because the duty to enforce the rules arose after the loss had taken place, there was no causal connection between the violation of that duty and the plaintiff's loss, and the Exchange could therefore not be held liable.

21. 141 F.2d at 244.

22. *Id.*

private right of action was required to effectuate the 1934 Act's underlying policies of complete and effective protection of the general investing public.[23] Since the *Baird* decision, only a few cases have considered the question of exchange liability under section 6. In *Pettit v. American Stock Exchange*,[24] a 1963 decision, the court, in denying the Exchange's motion to dismiss, rejected its argument that section 6 liability arose only when it had knowledge of member rule violations and held that the *Baird* rationale applied also to negligent violations of section 6. Four years later, however, the Seventh Circuit, in *Butterman v. Walston & Co.*[25] limited *Pettit* to situations involving a general deficiency of control[26] by an exchange and held that an exchange had no duty to supervise or review a member's activities; therefore an exchange could not be held liable under section 6 for failure to enforce its rules unless it had knowledge or reason to know of alleged violations by members.[27] In a 1971 declaratory judgment action, *Bright v. Philadelphia-Baltimore-Washington Stock Exchange*,[28] liability was found under section 6 for the Exchange's violation of one of its constitutional provisions pertaining to the election of governors. The court noted that while the provision was not promulgated under section 6(b), section 6(a)(3)[29] requires an exchange to file with the SEC a copy of its rules which are also subject to SEC scrutiny under section 6(d). The court reasoned that if rule enforcement is left to the whim of an exchange

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23. *Id.* at 244-45. Judge Clark elaborated on this rationale as follows:

> If § 6(b) here were to be construed as granting no right of action to plaintiffs, the avowed purpose of 'reasonably complete and effective' protection would indeed he a snare and a delusion.
>
> The fact that the statute provides no machinery or procedure by which the individual right of action can proceed is immaterial. It is well established that memhers of a class for whose protection a statutory duty is created may sue for injuries resulting from its breach and that the common law will supply a remedy if the statute gives none.

Id. at 245.

24. 217 F. Supp. 21 (S.D.N.Y. 1963).

25. 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968) (the court affirmed a summary judgement in favor of the New York Stock Exchange).

26. The Exchange was held not to be responsihle without knowledge of rule violations involving individual members' isolated transactions, the supervision of which would be impossible due to the large volume of such transactions. The Exchange, however, was still charged with the responsibility of exercising due care to insure the general compliance of its members with its rules. *See* Allen, *Liability Under the Securities Exchange Act for Violations of Stock Exchange Rules*, 25 Bus. Law. 1493, 1495 (1970).

27. Section 6 has also been used to hold an exchange *member* liable for violation of stock exchange rules. *E.g.*, Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969) (violation of N.Y.S.E. Rule 405 ("know your customer" rule)).

28. 327 F. Supp. 495 (E.D. Pa. 1971).

29. 15 U.S.C. § 78f(a)(3) (1970).

there would have been no purpose for its inclusion with the other rules that are subject to review under the 1934 Act. It concluded that an exchange has a duty to enforce rules applicable to its internal organization as well as rules dealing with member discipline, the subject of the litigation in the earlier cases.[30] An approach different from the implied statutory private right of action found in *Baird* was used in *Weinberger v. New York Stock Exchange.*[31] In that case, since plaintiff's remedy under *Baird* was barred by a three-year statute of limitations applicable to causes of action created by statute,[32] he alleged that an investor is a third party beneficiary of the Exchange's section 6 agreement with the SEC. The court denied the Exchange's motion to dismiss, reasoning that the congressional intent found in *Baird* to provide a remedy for exchange dereliction of duty made an investor more than an incidental beneficiary. While all of the foregoing cases continually reaffirmed an exchange's duty to enforce its rules under section 6, no case has ever given judgment against an exchange based on such a theory.[33] Moreover, the problem of establishing limits within which an exchange, by virtue of its self-regulatory nature, can exercise discretion in carrying out its section 6 duties has not been previously addressed. The question of exchange discretion in general was discussed in an antitrust action, *Silver v. New York Stock Exchange,*[34] in which the Supreme Court held that the Exchange had exceeded the scope of its regulatory authority by depriving non-member broker-dealers of direct wire connections with member firms. The Court took the opportunity to expound upon the extent to which the discretionary nature of exchange self-regulation precluded other causes of action against an exchange and to point out the role of exchange rules in effectuating the policies of the 1934 Act. While it noted that one of the Act's purposes was to make an exchange a self-regulatory body,[35] its duties of self-regulation were not found to be incompatible with the maintenance of an antitrust action.[36] It also pointed out that it regarded the Exchange rules promulgated under section 6 as part

30. 327 F. Supp. at 502.

31. 335 F. Supp. 139 (S.D.N.Y. 1971).

32. N.Y.C.P.L.R. § 214(2) (McKinney 1963). The third party beneficiary theory was necessary to bring plaintiff within a six year statute of limitations applicable to contractual obligations. N.Y.C.P.L.R. § 213(2) (McKinney 1963).

33. *See* Note, *Exchange Liability for Net Capital Enforcement*, 73 COLUM. L. REV. 1262, 1274 (1973).

34. 373 U.S. 341 (1963).

35. *Id.* at 352-53.

36. *Id.* at 358-59.

of the fulfillment of its duties under the 1934 Act.[37] Citing this purpose of making the exchange a self-regulatory body recognized in *Silver*,[38] the Fifth Circuit, in *Intercontinental Industries v. American Stock Exchange*,[39] held that an exchange should be accorded broad discretion in the determination of the meaning and application of its rules. The court upheld an SEC finding that the Exchange had correctly interpreted its own rule that permitted delisting of a company's securities for its non-compliance with Exchange disclosure requirements. Taking into account the presence of SEC involvement in *Intercontinental*, that case cannot be said to have dealt with the nature and extent to which an exchange, without SEC approval, could exercise discretion in carrying out its section 6 duties.

The instant court first recognized that section 6 grants broad regulatory powers to a national securities exchange and that there is concomitant discretion in carrying out that authority. Nonetheless, an exchange's agreement to enforce rule compliance of member firms under the 1934 Act and the section 6(b) requirement that an exchange's rules provide for the expulsion, suspension, or discipline of a member for conduct inconsistent with just and equitable principles of trade were found to indicate that regnlation by an exchange is not absolutely discretionary. The court distinguished the broad discretionary approach in *Intercontinental* as being applicable only when an exchange is applying one of its rules with the approval of the SEC, while the instant case involved the alleged failure to apply a rule with no such approval. Citing *Baird, Bright,* and *Weinberger*, the court stated that a cause of action does lie against an exchange for violation of its section 6 duties to enforce its rules. Moreover, the court found the Supreme Court's *Silver* holding—that the self-regulatory nature of an exchange's duties does not preclude an antitrust action—equally applicable in the context of a securities fraud action. The court then turned to the issue of whether the Exchange had abused its discretion by not suspending the broker-dealer. It

37. The Court stated:

In light of the important role of exchanges in our economy and the 1934 Act's design of giving the exchanges a major part in curbing abuses by obligating them to regulate themselves, it appears conclusively . . . that the rules applied in the present case are germane to the performance of the duty, implied by § 6(b) and § 6(d), to have rules governing members' transactions and relationships with non-members.

Id. at 356. *See* Lowenfels, *Implied Liabilities Based Upon Stock Exchange Rules*, 66 COLUM. L. REV. 12, 20-21 (1966).

38. 373 U.S. 341, 352-53 (1963).

39. 452 F.2d 935 (5th Cir. 1971).

noted that the Exchange's discretionary applications of its rules and approval of the subordination agreement were designed to rescue the broker-dealer from financial collapse, in order to protect its creditors and to prevent a general market loss of confidence, which would adversely affect other firms within the Exchange's responsibility.[40] With these goals in mind, the court reasoned that to hold the Exchange liable would place it in the impossible position of making an ultimate choice between submitting to a form of strict liability for the potential risks inherent in similar rescue schemes or foregoing equally important legal and ethical obligations to other members of its national organization and their clients. This choice, the court concluded, would eliminate the fundamental flexibility and discretion necessary for the effective functioning of a national securities exchange.[41] Having found that the Exchange's actions were a good faith exercise of its discretion, the court held that the Exchange had not breached its duty to enforce its rules under section 6 of the Securities Exchange Act of 1934.[42]

The instant decision represents a significant development in the law of stock-exchange liability.[43] While *Baird* and its progeny continually have reaffirmed and expanded the availability of a private right of action for failure to enforce stock exchange rules, this is the first case to hold that a good faith exercise of discretion by an exchange in enforcing its rules will exempt it from such liability. The statutory framework is broad in scope. First, section 6(b) of the 1934 Act is phrased only in general terms; it requires that exchange rules provide for the expulsion, suspension, or discipline of a mem-

40. The loss of confidence in the hrokerage industry by the demise of the broker-dealer in the instant case was viewed as a potential cause of investor withdrawal from the securities markets—an effect that in turn would aggravate precarious financial positions of other member firms.

41. The court also noted that Congress has recognized the dilemma thrust upon an exchange hy such a situation and has provided a method whereby it could be avoided. The court pointed out that by enacting the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa *et seq.*, Congress has provided a statutory scheme whereby such crises can he anticipated, dealt with, and resolved on a fair and equitable basis. This is accomplished largely by giving the Securities and Exchange Commission broad powers to take affirmative action with respect to the conditions that might result in the financial crisis involved in the instant situation after it has been given notice of such conditions. CCH FED. SEC. L. REP. ¶ 94,133, at 94,546-47 n. 29. *See* Note, *The Securities Investor Protection Act of 1970: A New Federal Role in Investor Protection*, 24 VAND. L. REV. 586 (1971).

42. The court also found that the Exchange was not liable on plaintiff's other alleged causes of action. *See* note 5 *supra*.

43. The decision's precedential value is especially important since the liquidity crunch of 1969-1970 has engendered approximately 25 suits against registered national securities exchanges alleging facts similar to the instant case. Wall Street Journal, Feb. 13, 1973, at 1, col. 6.

ber for conduct inconsistent with just and equitable principles of trade.[44] Secondly, the rules promulgated by the Exchange and found by the SEC to be in compliance with section 6 are also very broadly stated. They require suspension only upon a finding by the Exchange of certain specific conditions,[45] and the Exchange can still "remit or reduce" a penalty of suspension or expulsion.[46] It is thus apparent that some exercise of discretion by the Exchange is required. In spite of the rules' lack of specific guidelines concerning its exercise, however, *Baird* and subsequent cases did not consider the breadth of permissible exchange discretion. This omission may explain in part the fact that *Baird* and its progeny have uniformly refused to hold an exchange liable for nonenforcement of rules although expressly recoguizing such a cause of action.[47] The instant decision, by addressing the question of exchange discretion in rule enforcement, has provided a new framework under which an exchange's section 6 liability can be determined. In using their newly formulated approach, the court viewed the Exchange's failure to suspend the broker-dealer in light of the Exchange's concurrent obligations to the creditors of the broker-dealer, to its other members, and to the investing public. While a strict reading of the Exchange rules might mandate suspension,[48] thus making the Exchange liable in light of the *Baird* rationale, the discretionary aspects of both section 6 and the Exchange rules provide a defense when an exchange acts in good faith to carry out all of its obligations.[49] In refusing to force the Exchange to choose between the interests of a single firm and its creditors and those of the remaining member firms and their creditors, the court's decision is both logical and consistent with the multiple responsibilities placed upon an exchange by the 1934 Act. As the court points out, Congress, after the accrual of plaintiff's cause of action, recognized this dilemma and provided a method to avoid such crises in the future through enactment of the Securities Investor Protection Act of 1970.[50] The

44. 15 U.S.C. § 78f(b). *See* text of statute cited note 4 *supra*.

45. N.Y.S.E. CONST. art. XIII, § 2, cited note 13 *supra*.

46. N.Y.S.E. CONST. art. XIV, § 13, cited note 13 *supra*.

47. *See* Note, *Exchange Liability for Net Capital Enforcement*, 73 COLUM. L. REV. 1262, 1274 (1973).

48. *See* rules cited note 13 *supra*.

49. While it might be thought that the reasoning of the instant decision would be equally applicable in the context of an antitrust action, it should be noted that the majority in *Silver* did not take the view set forth in Justice Stewart's dissenting opinion that good faith action by an exchange to effectuate its statutory duty of self-regulation would exclude it from antitrust liability. 373 U.S. at 371.

50. 15 U.S.C. § 78aaa *et seq.* (1970). *See* note 41 *supra*.

Act requires that either the SEC or the appropriate "self-regulatory body" notify the Securities Investor Protection Corporation (S.I.P.C.) of any member firm experiencing financial difficulty.[51] The S.I.P.C. may apply for a district court decree adjudicating the member firm in need of protection under the Act, and the court is empowered to undertake a variety of measures upon such a finding.[52] Subordinated lenders such as the plaintiff in the instant case are excluded from the Act's protection.[53] As the court noted, however, the Investor Protection Act would have the effect of creating a higher profile of the risks involved in becoming a subordinated lender since the same circumstances that would lead a broker-dealer to seek a subordination agreement would also probably require the initiation of liquidation proceedings under the Act, thus putting a potential subordinated lender on notice of those risks.[54] Nonetheless, at the time of accrual of plaintiff's cause of action, this statute was not in force, and the Exchange had a more pervasive regulatory role in dealing with financially distressed members. Performance of this type of role requires considerable flexibility if an exchange is to function viably under such unusual conditions of economic distress, and the instant decision effectively combines the *Baird* rationale with the discretionary elements of the 1934 Act and the Exchange rules in this context. Moreover, the logic of the instant decision does not appear to be limited only to situations where an exchange makes discretionary rule applications regarding financially distressed members. The good faith defense seems equally applicable in all instances of discretionary exchange rule applications. Such an extension of the instant case, however, necessarily would put an exchange composed of broker-dealers in a position to make policy decisions affecting not only themselves, but also their creditors and the investing public. The weilding of large amounts of broad discretionary power by this type of body may be inappropriate, especially in times of an economic crisis. To remedy this situation, increased involvement of the SEC would seem to be a better method of balancing the competing interests. In the financially distressed broker situation, the Securities Investor Protection Act of 1970 has specifically empowered the SEC to take certain remedial steps, which include the alteration of exchange rules and regulations, the ability to require reports on the financial condition

51. 15 U.S.C. § 78eee(a)(1) (1970).

52. 15 U.S.C. §§ 78fff, ggg, iii (1970).

53. 15 U.S.C. § 78fff(c)(2)(A)(ii) (1970).

54. CCH FED. SEC. L. REP. ¶ 94,133, at 94,547 n. 29.

of members, and the power to inspect any exchange or member thereof with respect to its financial condition.[55] Similarly, in other situations, if an exchange could engage in discretionary rule enforcement only with SEC approval, less chance would exist for unfairness and abuse of discretion. This approach would be consistent with the Fifth Circuit's *Intercontinental Industries* holding that it is proper to accord broad discretion to an exchange in the determination of the meaning and application of its rules when the SEC previously has given its approval. An additional solution might be to require the Exchange to revise its rules to clarify the limits of discretion in rule application. In this regard, Professor Davis, while recognizing that significant discretionary power is necessary for the accomplishment of the main objectives of modern government, has stated that not only should unnecessary discretionary power be eliminated, but necessary discretionary power should be properly confined, structured and checked.[56] He has further stated that administrative standards and safeguards provide a highly significant method for protection against the arbitrary exercise of discretionary power.[57] This logic is equally applicable in the context of a private self-regulatory body and the above mentioned revisions of the Exchange's rules would eliminate the current high degree of uncertainty concerning the extent of permissible rule-enforcement discretion created by the general wording of the Exchange rules. Further, in revising its rules the Exchange could indicate those interests that in its opinion must be evaluated in its discretionary exercise of the rule-enforcement duty. These guidelines could serve as a useful tool to the courts, the public, and the Exchange itself in assessing the propriety of an actual or proposed discretionary rule application in light of the policies of both the 1934 Act and the Exchange rules.

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55. 15 U.S.C. § 78iii(f) (1970).

56. K. DAVIS, ADMINISTRATIVE LAW § 4.03 (1972).

57. *Id.* § 6.05. Davis advocates that the courts should require administrative rulemaking to limit discretion:

> [B]oth federal and state courts should . . . move from statutory standards to administrative standards and administrative safeguards, and then . . . to the totality of protections against arbitrariness. *The courts should develop a requirement that as far as practicable administrators must structure their discretionary power through appropriate safeguards and must confine and guide their discretionary power through standards, principles, and rules.*

Id. § 2.10 at 52. (emphasis in original). *See* Environmental Defense Fund v. Ruckelshaus, 439 F.2d 584, 598 (D.C. Cir. 1971) (court required the Secretary of Agriculture to state reasons and clarify the standards he applied in refusing to suspend the federal registration of DDT as a pesticide).

Taxation—Business Expense Deduction—Section 162(a)(3) Deduction Allowed for Rent Payments Made by Reversioner Under Gift-to-Trust and Leaseback of Business Property

Taxpayers, husband and wife, created separate irrevocable trusts for the benefit of each of their four minor children by transferring equal undivided interests in their funeral-home building to their attorney as trustee. The trust instruments provided that after a term of ten years and one day the corpora of the trusts were to revert to taxpayers or their estates.[1] Taxpayers,[2] by prearrangment, leased the funeral home from the trustee for a fifteen-month period shortly after executing the trust instruments. The initial lease was followed by a new one-year lease that afforded taxpayers an option to renew annually upon terms mutually agreeable to the parties.[3] During the years in question 1964-66, taxpayers deducted the rent payments[4] as ordinary and necessary business expenses under section 162(a)(3) of the Internal Revenue Code.[5] The Commissioner disallowed the deductions on the ground that taxpayers' reversionary interest was a disqualifying "equity" in the rental property. On petition to the Tax Court, *held*, a reversionary interest not derived from the lease or the lessor, which becomes possessory only after the expiration of the lessor's term of years, is not a disqualifying "equity" under section 162(a)(3). *C. James Mathews*, 61 T.C. No. 3 (Oct. 3, 1973).

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1. Fearing possible adverse tax consequences, and because the taxpayers later became willing and able to relinquish their reversionary interests in the trust, taxpayers executed a subsequent trust agreement in 1966, transferring their reversionary interests in the funeral home property to a new irrevocable trust for the benefit of their four children.

2. The funeral home property actually was leased to the husband alone. However, husband and wife filed joint federal income tax returns from which the deductions in issue were taken, so the reference "taxpayers" seems appropriate.

3. Renewals of the one-year lease were in effect during the years in question.

4. Taxpayer paid $14,310, $14,040, and $14,040 as rent for the calendar years 1964, 1965, and 1966 respectively.

5. All Internal Revenue Code references are to the Internal Revenue Code of 1954. Section 162(a)(3) provides:

(a) In General—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

> . . . .
>
> . . . .
>
> (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

A progressive income tax encourages the taxpayer with income above his consumption level to attempt to shift the excess income to other persons, frequently members of his family, in an effort to incur a lower total amount of tax liability. The gift-to-trust and leaseback device is commonly used by individuals engaged in professional or service-oriented enterprises in attempting to shift their income. This arrangement usually involves a transfer by gift[6] of some form of business property, for example an office building, to a trust for the benefit of certain members of the grantor's family. Thereafter, typically by prearrangement, the grantor and trustee enter into an agreement whereby the trust property is leased back to the grantor for a reasonable rent.[7] The tax-planning objectives of the gift-to-trust and leaseback are the inclusion of the rental amount in the trusts' or beneficiaries' gross income and the deduction of that amount from the grantor's gross income.[8] To achieve these objectives, the trust first must comply with the *Clifford* rules,[9] now codified in sections 671-78 of the Internal Revenue Code,[10] which set forth standards for determining whether the trust is the "owner" of the trust corpus, which in turn governs whether the income produced by the corpus is taxable to the trust and its beneficiaries, or to the grantor.[11] Under these standards, the trust is the

6. The grantor of a short-term trust is deemed to have made a gift of the present value of the rental income of the property for federal gift tax purposes. INT. REV. CODE OF 1954, §§ 2511-12. As long as the income of the trust is required to be distributed periodically to the beneficiaries, the gift is one of a present interest in property, and the grantor may take a § 2503(b) exclusion. In addition, the grantor may claim the § 2521 exemption and may utilize the § 2513 split-gift treatment if he is married and if his spouse has consented to such treatment. Thus, the gift tax incurred is likely to be minimal after the application of the above sections to the present value of the income. *See* 1 A. CASNER, ESTATE PLANNING (3d ed. 1961); Note, *The Use of Business Property As Short-Term Trust Corpus*, 19 VAND. L. REV. 811, 814 (1966).

7. For variants of this basic plan see Note, *The Use of Business Property As Short-Term Trust Corpus*, 19 VAND. L. REV. 811, 813 (1966).

8. The tax savings of the gift-to-trust and leaseback arrangement is dependent upon, first, the difference between the grantor's tax bracket and the trust's or beneficiaries' tax brackets; secondly, the amount of gift tax incurred by the grantor; and thirdly, the amount by which the rental deduction under § 162(a)(3) exceeds the depreciation deduction under § 167 of the Internal Revenue Code of 1954, assuming the asset is depreciahle and has not been fully depreciated. The attractiveness of the gift-to-trust and leaseback transfer would seem especially great where the asset has been fully depreciated and no further deduction is possible.

9. The rules derive their name from the Supreme Court decision of Helvering v. Clifford, 309 U.S. 331 (1940). The case set forth rules for the determination of the question whether trust income was taxable to the grantor or to the trust (or trust beneficiaries) in a short-term trust situation.

10. INT. REV. CODE OF 1954, §§ 671-78.

11. It is a well-known principle that income from property is taxed to the owner of that

owner of the trust corpus if the following conditions are satisfied: no reversionary interest in the grantor will take effect for ten years;[12] certain prohibited powers over the disposition[13] or the administration[14] of the trust corpus or income are not retained by the grantor; the trust is irrevocable;[15] and the corpus or income of the trust is not used for the grantor's benefit.[16] It is improper to assume, however, that simply because rental income is taxable to a trust under the *Clifford* sections, such rental payments are deductible by a grantor as business expenses under section 162(a)(3).[17] A grantor seeking to deduct rental payments made to a short-term trust under a leaseback agreement must establish that such payments come within the ambit of section 162(a)(3) and that the gift-to-trust and leaseback arrangement is valid according to judicially developed standards. First allowed in 1916,[18] section 162(a)(3) deductions are permitted for all ordinary and necessary expenses paid or incurred during a taxable year in carrying on a trade or business, including rentals or other payments required to be made as a condition to the continued use or possession of property to which the taxpayer has not taken or is not taking title, and in which he has no "equity". The term "equity", however, is not defined in the Code, and legislative history is silent with respect to its intended meaning.[19] Scholars in the area generally agree that the language was intended to close a loophole whereby mortgagors were allowed business deductions for principal payments on mortgage contracts.[20] *Skemp v. Commissioner*[21] is the earliest case that deals with intra-family shifting of income in the

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property. A corollary to that principle is the assignment of income doctrine, which states that income is taxed to the person who earns it, thus discouraging attempts to shift such earned income.

12. INT. REV. CODE OF 1954, § 673(a).
13. INT. REV. CODE OF 1954, § 674.
14. INT. REV. CODE OF 1954, § 675.
15. INT. REV. CODE OF 1954, § 676.
16. INT. REV. CODE OF 1954, § 677-78.
17. Treas. Reg. § 1.671-1(c) (1971). The regulation reads in part: "[t]hese sections have no application in determining the right of a grantor to deductions for payments to a trust under a transfer and leaseback arrangement."
18. Statutory language similar to § 162(a)(3) first appeared in Revenue Act of 1916, § 12(a)(1st), 39 Stat. 756, 767.
19. S. Rep. No. 793, 64th Cong., 1st Sess. (1916); H.R. Rep. No. 922, 64th Cong., 1st Sess. (1916), *as cited in*, Note, *The Use of Business Property As Short-Term Trust Corpus*, 19 VAND. L. REV. 811, 820 (1966). Neither report provides any clue to the purpose of the adoption of the word "equity".
20. See, 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.108 (1972); Note, *Tax Treatment of the Lease With Option to Purchase: Is Allocation the Answer?*, 11 TAX L. REV. 65 (1955).
21. 168 F.2d 598 (7th Cir. 1948), *rev'g* A.A. Skemp, 8 T.C. 415 (1947).

gift-to-trust and leaseback context. The controversy in *Skemp* centered around a twenty-year irrevocable trust created for the benefit of a physician's wife and children. Taxpayer had transferred his medical building to a trust, managed by an institutional trustee, which leased it back to him for ten years at a reasonable rental with an option to renew for another ten years. The trustee was directed to pay the rental income of the trust to the beneficiaries, and ultimately to distribute the corpus to taxpayer's children.[22] The Seventh Circuit rejected the Commissioner's argument that, because the grantor had voluntarily created the situation which required the payment of rent, the rental deductions[23] should be disallowed. In allowing the deduction it reasoned that, unless a violation of the fiduciary duty could be imputed to the trustee, the taxpayer had a legal obligation to make rental payments as a condition to the continued use and possession of the property.[24] Similarly in *Brown v. Commissioner,*[25] the Third Circuit allowed rental deductions in a gift-to-trust and leaseback situation in which the leaseback was prearranged, the rental payments were reasonable, taxpayers' attorney was named trustee, and the taxpayers did not retain a reversionary interest in the trust corpus.[26] It rejected the Tax Court's characterization of the transaction as a mere gift of income, singling out the independence of the trustee as a controlling factor. The independent trustee was in the position to require the payment of rent; the fact that he did require such payments, without regard to whether the taxpayers' operations on the leased property resulted in taxable income, made the payments properly deductible from gross income by the taxpayers. Shortly thereafter, however, in *White v. Fitzpatrick,*[27] a taxpayer was denied a deduction for rental and royalty payments made directly to his wife. The Second Circuit, feeling that *Skemp* and *Brown* "go to the verge of the law," distinguished them as involving independent trustees.[28] The taxpayer in *White*

22. The taxpayer retained no reversionary interest in the trust corpus.

23. The deductions were claimed under a predecessor of § 162(a)(3). INT. REV. CODE OF 1939, § 23(a)(1)(A).

24. The court indicated that the agreement between the taxpayer-grantor and the trustee was as binding as if the taxpayer had rented a place to practice medicine wholly apart from the trust corpus.

25. 180 F.2d 926 (3d Cir. 1950), *rev'g* Helen C. Brown, 12 T.C. 1095 (1949), *cert. denied,* 340 U.S. 814 (1950).

26. The corpus of the trust was coal-producing property. There was no reversion in the taxpayers-grantors under the trust instrument, but the period of the lease was estimated to be long enough to exhaust the coal in the leased land, and the land was probably without significant value once the coal was removed. *Id.* at 930 (Kolodner, J., dissenting).

27. 193 F.2d 398 (2d Cir. 1951), *cert. denied,* 343 U.S. 928 (1952).

28. *Id.* at 401.

had made a direct gift to his wife and entered into an oral leaseback. The court found that the practical effect of the transaction was to create a right to income in the wife, while leaving untouched the taxpayer's effective dominion and control over the gift property.[29] The first in the more recent line of cases[30] involving a gift of business property to a short-term trust with a leaseback is *Hall v. United States*.[31] The Commissioner argued for the first time in *Hall* that the taxpayers, because of their reversionary interest in the corpus of the trust and their right to settle the account of the trustee, had retained in the leased property an "equity" of the type which should preclude a section 162(a)(3) deduction for rental payments. The court, although it made no attempt to define the word "equity", apparently accepted this proposition as an alternative basis for their decision that the rental deductions were not allowable. The principal bases for the decision, however, were that the transaction lacked a valid business purpose, which the court felt was required implicitly by section 162(a)(3), and that the trustee lacked the requisite independence.[32] The Commissioner once again advanced his contention that a reversionary interest in the taxpayer-grantor is a disqualifying "equity" under section 162(a)(3) in *Van Zandt v. Commissioner*.[33] The Fifth Circuit, while denying the taxpayer a rental deduction, emphasized the importance of a factual evaluation of each particular case. The court stressed the taxpayer's dual role as grantor and trustee in finding that the requirement of independence was not satisfied. Viewing the transaction as an integrated

29. There was a strong dissent by Chase, Circuit Judge.

30. For a discussion of other early cases in the area see Oliver, *Income Tax Aspects of Gifts and Leasebacks of Business Property in Trust*, 51 CORNELL L.Q. 21 (1965).

31. 208 F. Supp. 584 (N.D.N.Y. 1962). Each of 3 doctors practicing as a partnership owned, together with their respective wives, an undivided one-third interest in an office building. A portion of the building was leased to other occupants, and the 3 doctors had their offices in the remaining portion of the building. Each doctor and his wife transferred their interest in the building to a corporate trustee, and 2 days later the partnership entered into a leaseback for the space it occupied. The rental payments were reasonable. Each of the 3 trust instruments named the grantors' children as beneficiaries. Each trust was to last until the death of a child of the grantors, or either of the grantors, at which time the corpus would revert to tbe surviving grantor or pass under the will of the last surviving grantor. The grantors reserved the power to revoke, amend, or modify the trust after 10 years.

32. The court apparently inferred the trustee's lack of independence from the fact that the taxpayers-grantors had a reversionary interest and a right to settle the trustee's accounts, which compromised his freedom of action.

33. 341 F.2d 440 (5th Cir. 1965), *aff'g* I.L. Van Zandt, 40 T.C. 824 (1963), *cert. denied*, 382 U.S. 814 (1965). The taxpayer, a physician, created 2 irrevocable short-term trusts whose corpus was an office building and equipment he owned. The taxpayer named himself as trustee, and executed a leaseback agreement with himself as an individual on the date of the execution of the trust instrument. The taxpayer retained a reversion.

whole, the court further found that the obligation to pay rent was not an "ordinary and necessary" expense incident to the conduct of the taxpayer's business under section 162(a)(3), but was designed merely to effectuate his desire to shift his income for tax purposes. Concluding that the transaction did not have a valid business purpose, the court disallowed the rent deduction without addressing the "equity" issue. A view contrasting with that of *Van Zandt* was presented by the Tax Court in the same year in *Alden B. Oakes.*[34] The Tax Court held that when a taxpayer transfers business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary to inquire whether there was a business purpose for the gift, for if there is a valid post-gift business purpose *for the lease*, rental payments to the trust are deductible. In effect the *Oakes* approach applies the test of business purpose only to the leaseback, while the *Van Zandt* approach applies it to the whole transaction. The court in *Oakes* noted that the absence of a reversionary interest in the taxpayer and the independence of the trustee were important factors in its decision. In dicta the court indicated that the retention of a reversionary interest by the taxpayer would have constituted a prohibited "equity" in the property, requiring denial of the rental deduction under section 162(a)(3).[35] The court stated that "[i]n legal parlance one has an 'equity' in property when he has a right of redemption, a reversionary interest, a right to specific performance, or in general any right respecting property which traditionally would have been enforceable by means of an equitable remedy."[36] Although the court's consideration of the meaning of "equity" was not necessary to the determination of the issue in *Oakes,* its treatment was an indication that the term is susceptible to very broad and literal interpretation. More recently, a federal district court exhibited considerable uncertainty as to the meaning of the term "equity" in *Chace v. United States.*[37] The taxpayer in *Chace* created a ten-year trust for the benefit of his children with the corpus to revert to the taxpayer. The

34. 44 T.C. 524 (1965). Taxpayers, a physician and his wife, conveyed a jointly-owned building to a corporate trustee. The trust was irrevocable, and its duration was 11 years after which time the corpus would revert to the taxpayers. The taxpayers' children were the beneficiaries of the trust. Two days after the trust instrument was executed the trustee entered into a leaseback agreement with the physician. Prior to the taxable years in question, the physician transferred his reversion to his wife so as to make her the sole owner of the reversion.

35. 44 T.C. at 531.

36. *Id.*

37. 303 F. Supp. 513 (M.D. Fla. 1969), *aff'd per curiam,* 422 F.2d 292 (5th Cir. 1970).

leaseback of the office building, which constituted the trust corpus, granted the taxpayer the right to renew the lease at the same annual rental payments for a period of time that extended beyond the length of the trust. The district court, relying on *Van Zandt*, held that no business purpose was accomplished by the transaction and therefore disallowed the section 162(a)(3) rental deduction. In addition, the court indicated that the taxpayer had a disqualifying "equity" interest in the property. Although the court was unclear on this point, presumably the taxpayer's unqualified right to renew the lease for a length of time in excess of the trust's duration, plus the reversion in the taxpayer, constituted the forbidden "equity." The most recent case in the gift-to-trust and leaseback area, *Gibbons v. United States,*[38] directly addressed the question whether a reversionary interest in the taxpayer-grantor is a prohibited "equity" under sections 162(a)(3). The court, without elaboration, held that a reversionary interest in the trust corpus constitutes a prohibited "equity" under section 162(a)(3), and consequently denied the taxpayer a deduction for rental payments. Thus, while the precise impact of the retention of a reversion by a taxpayer-grantor in a gift-to-trust and leaseback situation has not been clear, previous authority seemed to indicate that such a reversion would be treated as a prohibited "equity" in the rental property under section 162(a)(3).

In the instant case, the Tax Court, through analysis of prior decisions, determined that rental payments by a grantor to a trustee in a gift-to-trust and leaseback situation are deductible under section 162(a)(3) only if three basic requirements are satisfied. First, the grantor must not retain substantially the same control over the property that he had before transferring such property to a trust. The use of an independent trustee will usually satisfy this requirement because of his fiduciary obligation to the beneficiaries and freedom from control of the grantor. Secondly, the leaseback agreement should be reduced to writing[39] and must require the payment of a reasonable sum as rent. Lastly, the leaseback, as distinguished from the gift of property to trust, must have a bona fide business purpose. The court stated that such a purpose may be established by demonstrating that the rental payments were both ordinary and

38. 70-1 U.S. TAX CAS. 83,347 (D.N.M. 1970). The taxpayer, a physician, created an irrevocable short-term trust for the benefit of his 5 children. The taxpayer transferred his office building to the trust and retained a reversionary interest. The leaseback entered into by the taxpayer and trustee was for a period of 10 years, and the taxpayer was to pay monthly rent.

39. *But see* Brooke v. United States, 468 F.2d 1155 (9th Cir. 1972) (rental payments deductible despite absence of written lease).

necessary and were required to be paid as a condition to the continued use of the property. The court found the gift-to-trust and leaseback transaction in question met these requirements. It then focused on the Commissioner's argument that a reversion scheduled to become possessory upon the termination of a short-term trust constitutes a disqualifying "equity" in the rental property under a literal interpretation of section 162(a)(3). In analyzing the general structure and purpose of section 162(a)(3) the court pointed out that most of the cases considering the intended meaning of "equity" ask whether a purported lease of property is in reality a sale; *i.e.*, does a portion of the supposed "rental" payments secure for the "lessee" not merely the right to use and possession during the lease term, but also an ownership interest, or "equity", in the leased property.[40] After acknowledging that such an application of section 162(a)(3) is reasonable, the court rejected the argument that the disqualifying "equity" contemplated by section 162(a)(3) includes a reversionary interest owned by the lessee prior to the lease agreement. The court felt the language of section 162(a)(3) belies such an interpretation when read in its entirety, for the wording suggests that Congress intended to prohibit deductions for rental payments under that section only when the taxpayer "takes," not "has", title to the rental property.[41] Reluctant to rely upon statutory construction, the court based its holding primarily on the fact that the Commissioner's interpretation of the language in question would produce such anomalous and unfair tax results in the present context that Congress could not have intended such a construction. For instance, under the Commissioner's interpretation the owner of a reversion subsequent to a 99-year lease would be precluded from deducting bona fide rental payments pursuant to a ten-year sublease agreement. The court also pointed out that the Commissioner's interpretation of "equity" would seem to bar the owner of an undivided interest in an asset from leasing the remaining interest from his coowner. Furthermore, the practical effect of the Commissioner's interpretation would be the systematic overstatement of a lessee's net

40. The court stated that purported rental payments that are a disguised purchase price of a "lessor's" property rights must be capitalized rather than deducted. *E.g.*, Benton v. Commissioner, 197 F.2d 745 (5th Cir. 1952); M&W Gear Co., 54 T.C. 385 (1970), *modified*, 446 F.2d 841 (7th Cir. 1971); Earl L. Lester, 32 T.C. 711 (1959); Chicago Stoker Corp., 14 T.C. 441 (1950); Judson Mills, 11 T.C. 25 (1948).

41. The court believed that Congress had in mind some on-going process in which the taxpayer "takes" title to the "rental" property from the lessor through the purported rental payments. The court found it difficult to read into the language of § 162(a)(3) a prohibition on pre-existing ownership of property rights in the asset other than "those owned or purportedly owned by the lessor and subject to the lease."

income for each year in which a part of the bona fide and necessary cost of earning that income—rental payment—was disallowed as a deduction. The court, consequently, concluded that the taxpayer's reversionary interest was not a prohibited "equity" in the rental property under section 162(a)(3) since it was not derived from the lease or from the lessor and was scheduled to become possessor only after the expiration of the short-term trust. The court stated that to the extent the holding in *Gibbons*[42] and the alternative holding in *Hall*[43] are inconsistent with its views, those decisions are rejected. Finally, the court distinguished the instant case from the previous Fifth Circuit decisions, particularly *Van Zandt*[44] and *Chace*,[45] due to the absence of an independent trustee in those cases.

The primary importance of the principal case is the court's refusal to extend the "equity" proviso of section 162(a)(3) beyond its traditional construction—a construction that simply precludes a business expense deduction for payments made by a mortgagor[46] or a long-term lessee with a purchase option[47] to acquire an ownership interest in property, as distinguished from payments made merely for the continued use and possession of such property. The Commissioner's broad and literal construction of the "equity" phrase ignores these traditional boundaries of section 162(a)(3)'s interpretation and application.[48] The payments under the leaseback agreement in the instant case were strictly for the use of the property and in no way added to the grantor-lessee's ownership interest therein. Consequently, since the other criteria for deductibility were satisfied,[49] such payments warranted deductions as legitimate business expenses. Although the court narrowly addressed the issue whether a reversionary interest was a disqualifying "equity" under section

42. *See* note 38 *supra* and accompanying text.

43. *See* note 31 *supra* and accompanying text.

44. *See* note 33 *supra* and accompanying text.

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

46. *See* notes 20 & 40 *supra* and accompanying text.

47. *See* 4A J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 25.109 (1972); Oliver, *Income Tax Aspects of Gifts and Leasebacks of Business Property In Trust*, 51 CORNELL L.Q. 21, 37 (1965). The underlying issue in the lease with the option to purchase cases was whether the supposed rental payments were partially applied toward the cost of purchasing the property, whereby the "lessor" would grant an option price on the rental property to the "lessee" below the fair market value of the property.

48. Justice Frankfurter, in his dissent in *Lewyt Corp. v. Commissioner*, 349 U.S. 237, 249 (1955), commented, "[w]hile one should sail close to the shore of literalness in dealing with the technical problems which are the subject matter of revenue laws, literalness of meaning affixed merely to a particular word or phrase may itself distort what the provision as an entity and in context conveys and therefore commands."

49. The Commissioner did not challenge the instant trust on any §§ 671-78 grounds.

162(a)(3), a reasonable inference from the court's opinion is that "equity" refers only to the acquisition of an equity or ownership interest in the rental property by virtue of making the rental payments. Thus, an interest of the lessee-grantor's that does not arise through the lease or from the lessor, and is limited to commence in possession only after the expiration of the lessor's term of years, is not a section 162(a) (3) "equity" interest. The instant court's determination that a reversion is not an "equity" interest is a step toward the coordination of judicial standards governing rental deductions in gift-to-trust and leaseback situations with the *Clifford* sections of the Code. The trust in question was clearly within the permissible standards of sections 671-78 and those sections clearly allow the retention of a reversionary interest by the grantor. The primary benefit of a *Clifford* trust is the opportunity it affords to temporarily transfer capital assets and have the income that they produce taxed to another. This benefit should be available equally to the individual who has accumulated investment property and the one who has accumulated business property. For such an arrangement to benefit the grantor of a trust whose corpus is business property, the income of the trust—rental payments under the leaseback—must not only be taxable to the trust, but must be deductible from the grantor's gross income as business expenses in order to avoid double taxation. To permit the grantor of a trust whose corpus is investment property to enjoy the advantages of a *Clifford* trust while retaining a reversion, and deny the same treatment to the grantor who establishes a trust whose corpus is business property, is indefensible. The disallowance of a rental deduction to the latter because of the mere existence of a reversion is discriminatory against the taxpayer whose wealth is in property used in his business as compared to the taxpayer whose wealth is in investment property. Congress could not have intended such a "distinction without a difference." Moreover, the fundamental question is why legal ownership of a reversion in business property should cause disallowance of an expense deduction when beneficial ownership and effective control over the property have been transferred to another for a substantial period of time. To achieve the same tax result taxpayer could have sold his property to a third party, transferred the proceeds to a trust meeting the requirements of sections 671-78, and leased the property from the purchaser or leased new property; in either case the taxpayer certainly would receive a section 162(a)(3) deduction for the rent paid. There is no logical justification for forcing the taxpayer to incur the inconvenience of contorted legal maneuverings to enjoy the benefits of a *Clifford* trust. The tax planner, however, should be careful that a short-term trust in which business property constitutes the corpus satisfies, first, the *Clifford* sections and regulations of the Code to ensure that the income will be taxed to the trust or the beneficiaries, and second, the three judicially created requirements identified by the instant court to have adequate grounds upon which to deduct the rental payments from the grantor's gross income. It is suggested that these statutory and judicially created standards provide the Commissioner and the courts with sufficient criteria for determining the legal status of a gift-to-trust and leaseback; absent an "equity" in the form of an ownership interest in the rental property derived through the lease or from the lessor, a section 162(a)(3) deduction should be allowed.

Taxation—Corporate Redemptions—Absent a Pre-Gift Agreement Obligating Taxpayer's Corporation to Redeem Stock Donated by Taxpayer to an Educational Institution, Post-Gift Redemptions Do Not Constitute Constructive Dividends to Taxpayer

Taxpayer, founder and majority stockholder of a closely-held corporation,[1] challenged deficiencies assessed by the Commissioner of Internal Revenue based on the failure to report proceeds from the redemption of the corporation's stock from an educational institution[2] as personal income. Taxpayer had made charitable contributions[3] of remainder interests in the stock[4] to the educational institution and had retained a life income interest.[5] Taxpayer maintained

1. Taxpayer also is vice president and a director of the corporation Grove, Shepard, Wilson & Kruge, Inc., which is engaged primarily in the construction of airfields, highway tunnels, and similar projects in the United States and abroad.

2. The educational institution, Rensselaer Polytechnic Institute (RPI), is a private, tax-exempt educational institution. Taxpayer is an alumnus of RPI, having received his engineering degree there in 1924.

3. Annual gifts were made by taxpayer from 1954 to 1968 under a "life income funds" plan, which provided that donor would receive any dividends and interest paid on securities during his lifetime while any capital application would inure to RPI. Generally, RPI offered donated shares to the corporation for redemption between one and 2 years after they were donated by taxpayer.

4. Taxpayer limited his charitable contribution deduction under § 170 of the Code to the value of the remainder interest received by RPI. INT. REV. CODE OF 1954, § 170.

5. Commissioner claimed deficiencies in taxpayer's taxable income for the years 1963 and 1964. Taxpayer had declared a taxable dividend of $4,939.28 and taxable interest of

that since the gifts of stock were completed gifts when made, he did not realize any income from the subsequent redemption. Although at the time of the gifts the taxpayer and donee made no agreement obligating the corporation to redeem the stock,[6] the Commissioner argued that the systematic nature of the gift-redemption cycle[7] and the degree of taxpayer's control over the transaction[8] indicated a mutual understanding pursuant to which the institution acted as a tax-free conduit for withdrawing funds from the corporation.[9] The Commissioner contended that the step-transaction doctrine[10] should be applied because the donation was merely the first step in a prearranged series of transactions; therefore, in substance, the redemption payments by the corporation were constructive dividend pay-

$2,535.75 in 1963 and $6,095.95 dividend and $3,540.81 interest in 1964 based on dividends paid to him by RPI from reinvestments made with the redemptions' proceeds. The Commissioner increased taxpayer's taxable income by $29,000 in 1963 and $25,000 in 1964—the amounts paid by the corporation to RPI in the redemption of its stock—thereby increasing taxpayer's taxes for each year by $13,000.

6. In a letter accompanying his initial donation, taxpayer made the gift suhject to certain qualifications, including the condition that the corporation could not be obligated to redeem any of the donated shares. While the corporation was not obligated to redeem the donated shares, under an agreement with the university, the corporation reserved the first option to redeem the stock at book value.

7. Because of the nature of its business, which required the investment of large sums of money over an extended period of time, the corporation was forced to maintain liquidity by holding large amounts of cash or other current assets. To conserve its cash, the corporation retained its earnings and refrained from paying cash dividends; therefore, in order to obtain the maximum benefit from its gift, RPI successfully offered the shares for redemption and invested the proceeds in more secure, income-producing property. Each offering by RPI initially was authorized by the Finance Committee of the Board of Trustees. RPI's treasurer then notified the president of the corporation, who would call a special meeting of the corporation's Board of Directors. The Board would adopt a resolution authorizing the redemption and mail a company check to the treasurer. RPI then would return the appropriate stock certificate to the corporation for cancellation.

8. Taxpayer conditioned his gift on RPI's agreement that if it disposed of any of the donated shares, any proceeds would be invested and managed by an established professional firm. In compliance with this agreement, RPI opened an investment account with Merrill Lynch, Pierce, Fenner & Beane at the time of the first redemption. RPI authorized Merrill Lynch to act directly upon the investment recommendations made by taxpayer's personal investment advisor, who generally instructed that the redemption proceeds be invested in securities of large corporations whose shares were traded on organized stock exchanges.

9. The Commissioner contended that taxpayer was able to achieve a bail-out from his nondividend-paying close corporation because of his retention of a life income interest in the reinvestment proceeds and of his retention of control over how those proceeds were reinvested.

10. The step-transaction doctrine has been defined in terms of its application in 4 situations. The doctrine has been applied by the courts (1) to combine 2 or more steps into a single transaction; (2) to characterize a single event as 2 or more significant tax transactions; (3) to reorder the sequence of transactions; and (4) to determine the character of an event in considering what steps actually constitute a transaction described by tax law. Hobbet, *The Step Transaction Doctrine and Its Effect on Corporate Transactions,* 19th TUL. TAX INST. 102, 103-04 (1970).

ments to the taxpayer followed by cash gifts to the institution.[11] Rejecting the Commissioner's contentions, the Tax Court[12] sustained taxpayer's challenge by holding that the gifts to the educational institution were bona fide and that the redemptions of the donated stock were independent transactions. On appeal to the Court of Appeals for the Second Circuit, *held,* affirmed. In the absence of an agreement obligating taxpayer's corporation to redeem stock donated by him to an educational institution, the gifts of stock to the institution and the subsequent redemptions are independent transactions and therefore fail to subject taxpayer to constructive dividend treatment of the redemption proceeds. *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973).

Under the step-transaction doctrine, which often is applied interchangeably with judicial examination of a transaction's substance as opposed to its form,[13] the courts may refuse independent treatment of the various steps in an integrated transaction and consequently may regard the sum of the steps as a single transaction for tax purposes.[14] Initially, the Commissioner invoked the doctrine with consistent success, persuading the courts to ignore the form adopted by the taxpayer and to examine the actualities of the transaction in determining tax liability.[15] This early successful application of the doctrine was justified on the ground that its nonapplication would allow the taxpayer, not Congress, to determine the time and manner of taxation.[16] In the landmark case of *Gregory v. Helvering,*[17] in which the doctrine was applied because there was no business purpose for each allegedly independent step in the transaction, the Supreme Court acknowledged, however, that the taxpayer

11. By viewing the transaction as a series of interrelated steps, the Commissioner argued that the redemption proceeds would be taxable as income to taxpayer. Moreover, because taxpayer continued to control a majority of the outstanding shares of the corporation, it is likely that the proceeds would be taxed as a dividend payment at progressive ordinary-income rates rather than as a sale of shares at lower capital gains rates. *See* INT. REV. CODE OF 1954, §§ 302(a), (b).

12. Philip A. Grove, 31 CCH Tax Ct. Mem. 387 (1972).

13. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945); Weiss v. Stearn, 265 U.S. 242, 254 (1924).

14. In a classic example of judicial application of the step-transaction doctrine, Gregory v. Helvering, the Court combined the formation of a subsidiary, the transfer of securities to it, a distribution of the stock to the subsidiary, and then the liquidation of the newly organized company into one transaction. As a single transaction, these events did not constitute a reorganization as alleged but merely a distribution of securities. 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934). *See* Hobbet, *supra* note 10, at 103.

15. Mintz & Plumh, *Step Transactions in Corporate Reorganizations,* N.Y.U. 12th INST. ON FED. TAX 247, 248 (1954). *See, e.g.,* Higgins v. Smith, 308 U.S. 473, 477 (1940).

16. Higgins v. Smith, 308 U.S. 473, 477 (1940).

17. 293 U.S. 476 (1935). *See* text of note 14 *supra.*

had a legal right to minimize the amount of his taxes by legal means;[18] accordingly, that the substance versus form argument may be advanced by taxpayers as well as the Commissioner.[19] In applying the step-transaction doctrine, the courts have devised numerous tests to determine whether a series of steps should be combined into a single transaction. The test most frequently applied by the courts has been the "mutual interdependency" test[20] under which the courts have combined separate steps into a single transaction if "the steps were so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the steps."[21] Under the related "business-purpose" doctrine, if the taxpayer has justified each step by an independent business purpose, the courts have not regarded the particular steps as fruitless even though the contemplated series of steps has not been completed.[22] In addition to these two major tests, the courts also have considered the intention of the parties, the period of time between the steps, and the net effect of the steps in determining whether to combine the steps into one transaction.[23] While the application of the step-transaction doctrine depends largely on the facts in a given case, the courts must also consider the context of the tax statute in determining the doctrine's applicability.[24] When a transaction described under the Code incorporates many events,[25] the courts have exercised considerable latitude in deciding whether the several steps in reality constitute a single integrated transaction. On the other hand, when the transaction is described by the Code as a single

18. Writing for the lower court, Justice Hand summarized this view: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d 809, 810 (2d Cir. 1934).

19. *See, e.g.,* Weinert v. Commissioner, 294 F.2d 750, 755 (5th Cir. 1961) ("Resort to substance is not a right reserved for the Commissioner's exclusive benefit, to use or not to use—depending on the amount of tax to be realized.").

20. R. PAUL & P. ZIMET, *Step Transactions,* in SELECTED STUDIES IN FEDERAL TAXATION 200, at 235-36 (2d ser. 1938) (hereinafter cited as PAUL & ZIMET).

21. *Id.* at 254. *See, e.g.,* American Bantam Car Co., 11 T.C. 397, 405 (1938), *aff'd mem.,* 177 F.2d 513 (3d Cir. 1949).

22. *See* Gregory v. Helvering, 293 U.S. 465 (1935), *aff'g* 69 F.2d 809 (2d Cir. 1934); H.B. Zachry Co., 49 T.C. 73, 81-84 (1967). Tax avoidance is not regarded as a "business purpose" under this test. Note, *The Evolution of the Step Transaction Doctrine,* 11 WASHBURN L.J. 84, 95 (1971).

23. Hobbet, *supra* note 10, at 108.

24. In certain sections of the Code, the step-transaction doctrine is incorporated into the statute. *See, e.g.,* INT. REV. CODE OF 1954, § 302(b)(2).

25. The most obvious sections are those dealing with corporate reorganizations. *See* Hobbet, *supra* note 10, 123-41.

event,[26] the courts have been reluctant to combine several steps into one transaction for tax purposes.[27] Although in the vast majority of cases the courts' rationale for applying the step-transaction doctrine has been clear, nevertheless, with respect to certain types of transactions the courts have been unable to formulate a precise test or rationale and have justified their application of the doctrine on the general ground that substance must prevail over form. A pertinent example of this judicial generalization occurred in *Commissioner v. Court Holding Co.*,[28] in which the Supreme Court implicitly applied the doctrine[29] to reorder the sequence of taxable events, stating that the incidence of taxation depends upon the substance of the transaction and that the transaction must be viewed as a whole. The *Court Holding Co.* case involved a post-liquidation sale of assets by shareholder-distributees as a result of negotiations that were initiated between the purchaser and the corporation before the liquidation; the Court held that because the corporation had never disassociated itself from the negotiations, the sale should be treated as if it had preceded the liquidation thereby resulting in income to the corporation. The Court characterized the shareholder as a mere conduit through which title was passed—a formalism that should not cloud the transaction's true nature. Four years later, the Commissioner, relying on the Court's decision in *Court Holding Co.*, sought to apply the substance versus form argument in *United States v. Cumberland Public Service Commission*,[30] a factually similar case, but the Supreme Court distinguished *Court Holding Co.* on the ground that a genuine dissolution occurred in *Cumberland* before the sale. Therefore the carefully advised taxpayers were able to structure their transaction to avoid the *Court Holding Co.* result.[31] Recognizing that the Court's two decisions created a trap for unwary taxpayers by emphasizing the transaction's form, Congress enacted section 337 which divorced "the tax consequences of the liquidation-sale combination from the form of the transaction."[32]

26. *E.g.*, a corporate distribution. INT. REV. CODE OF 1954, §§ 317(a), 355.

27. See Hobbet, *supra* note 10, at 105 & n.10.

28. 324 U.S. 331 (1945).

29. For authority citing Commissioner v. Court Holding Co. as a step-transaction doctrine case, see West Coast Marketing Corp., 46 T.C. 32, 41 (1966).

30. 338 U.S. 451 (1950), *aff'g* 83 F. Supp. 843 (Ct. Cl. 1949).

31. For an analysis of tbe *Court Holding Co.* and *Cumberland Pub. Serv. Comm'n* cases, see B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, ¶ 11.63 at 11-53 to 58 (abr. ed. 1971).

32. *Id.* at 11-58. Section 337 provides tbat a corporation will not recognize gain or loss from sale or exchange of property within a 12-montb period if the corporation adopts a plan

Several recent cases deciding the tax consequences of charitable contributions of close corporation stock by shareholders prior to liquidation or redemption have relied on either the substance versus form doctrine or the step transaction doctrine to justify the imposition of tax liability. In *Jacobs v. United States,*[33] a case of first impression dealing with a stock contribution followed by a liquidation, the Sixth Circuit affirmed the lower court's holding that the taxpayer did not make an assignment of income when he donated shares of a close corporation to a charity after the shareholders[34] had adopted a plan for complete liquidation but before the actual liquidation payments were made.[35] Ignoring the fact that the taxpayer controlled the corporation, the court reasoned that since a repudiation of the dissolution proceedings theoretically was possible until the actual payments were made, the taxpayer did not realize the liquidation proceeds at the time of the gift.[36] The procedure followed by the taxpayer in *Jacobs* had obvious tax advantages: by donating the gift of stock before the liquidation distribution the taxpayer avoided the tax on the liquidation proceeds, and at the same time received a charitable deduction. In the factually similar case of *Hudspeth v. Commissioner,*[37] however, the Eighth Circuit rejected the *Jacobs* rationale,[38] concluding that the substance and economic reality of the transaction were determinative.[39] The *Hudspeth* court held that, while abandonment of the liquidation proceedings technically was still possible at the time of the gift,[40] the essential factors in determining tax liability were the taxpayer's intent and control,[41] and by casting his vote for dissolution, the taxpayer had manifested

of complete liquidation within the 12-month period measured from the date of the adoption of the plan. INT. REV. CODE OF 1954, § 337(a).

33. 390 F.2d 877 (6th Cir. 1968), *aff'g mem.* 280 F. Supp. 437 (S.D. Ohio 1966).

34. The corporation was owned by the taxpayer, his relatives, and an employee.

35. On April 1, 1959, the corporation filed notice of its intent to liquidate with the Internal Revenue Service; on April 29, 1959, it filed its statement of intent to dissolve with the Secretary of State of Kentucky; on May 15, 1959, the Jacobs Family Foundation was incorporated as a nonprofit, charitable organization; during the period between May 15 and June 17, 1959, the taxpayer donated 90 shares to the foundation; and on September 24-28, 1959, the liquidation proceeds were paid.

36. 280 F. Supp. at 439.

37. 471 F.2d 275 (8th Cir. 1972), *rev'g* 335 F. Supp. 1401 (E.D. Mo. 1971).

38. The taxpayer owned 81% of the stock in the corporation, and his 2 sons owned the remainder. On April 10, 1964, the directors resolved to liquidate the corporation. On January 21, 1965, the taxpayer donated 67 shares of his stock to nine tax-exempt institutions. On March 12 and 29, 1965, the corporation filed its Articles of Liquidation with the state.

39. 471 F.2d at 277.

40. *Id.* at 280. The court dismissed the final filing requirements as mere formalities.

41. *Id.* at 278.

his intent to liquidate the corporation. Furthermore, the court reasoned that as majority stockholder the taxpayer was able to ensure that the liquidation proceedings would continue;[42] therefore, the court concluded that it was reasonable to tax the taxpayer as the recipient of the income.[43] Recently, the Second Circuit adopted the *Hudspeth* rationale in *Kinsey v. Commissioner,*[44] a case in which the taxpayer made a gift to a university of the controlling share[45] in a corporation after a plan of liquidation had been adopted. Although acknowledging that the liquidation proceeding could be repudiated,[46] the court, placing considerable emphasis on the transaction's surrounding circumstances and the taxpayer's intent, concluded that the adverse tax consequences of such a repudiation,[47] the university's policy of liquidating donated shares, and the taxpayer's obvious intention justified characterizing the substance of the transaction as an assignment of income. In cases examining the consequences of donations of close corporation stock prior to a *redemption,* the courts also have emphasized the substance of the transaction in determining whether the taxpayer received a constructive dividend from the redemption proceeds. In *Behrend v. United States,*[48] the taxpayers had donated stock of their close corporation to a family foundation prior to the subsequent redemption of the stock by the corporation. The Fourth Circuit held that the redemption proceeds did not constitute constructive dividends to the taxpayer because the gifts were complete before the corporation redeemed the stock.[49] Moreover, the court found that the taxpayer's control was limited to his control of the corporation and did not extend to the foundation. More importantly, the taxpayer did not receive any benefits from the foundation after his gift.[50] Recently,

42. "The liquidation had proceeded to such a point where we may infer that it was patently never taxpayer's intention that his donees should exercise any ownership in a viable corporation, but merely that they should participate in the proceeds of the liquidation." *Id.* at 279.

43. *Id.* at 280.

44. 477 F.2d 1058 (2d Cir. 1973), *aff'g* 58 T.C. 259 (1972).

45. The taxpayer transferred 51% of the stock in the corporation.

46. Under Connecticut law a two-thirds majority of the shareholders is required to adopt or to terminate a liquidation resolution previously adopted by the shareholders. CONN. GEN. STAT. ANN. §§ 33-376(c), -329(d). Therefore, it theoretically was possible for the university and another shareholder to block the liquidation.

47. The practical effect would have been to jeopardize the rights of the shareholders to treat previous distributions as capital gains rather than ordinary income.

48. 73-1 U.S. TAX CAS. 80,065 (4th Cir. 1972).

49. *Id.* at 80,067.

50. *Id.*

in *Carrington v. Commissioner*,[51] the Fifth Circuit held that when a close-corporation shareholder donated controlling stock to a church, in accordance with a plan to redeem the shares in exchange for a residence owned by the corporation to be used as a rectory, he did not realize an actual or constructive dividend. In rejecting the Commissioner's argument that the step-transaction doctrine should be applied to the transaction, the court found that the issue for determining the taxpayer's liability was whether the taxpayer had parted with all dominion and control over his gift.[52]

The instant court, recognizing that substance must prevail over form, observed that this maxim marked only the beginning of its inquiry in determining whether taxpayer's pre-redemption gifts to the institution should be given significance independent of the redemption.[53] The court noted that the Commissioner did not contest the lower court's finding that the gifts of stock were completed when made, and consequently reasoned that it would be pure fiction to treat the redemption proceeds as actually having been received by the taxpayer.[54] Next the court addressed the Commissioner's argument that, notwithstanding the validity of the gifts, other circumstances, including the systematic nature of the gift-redemption cycle, established that a mutually beneficial arrangement had been reached by which the taxpayer was permitted to use the tax-exempt status of the institution as a conduit for withdrawing funds from his closely-held corporation without incurring any tax liability. First, the court found that taxpayer's post-gift position as majority stockholder was itself insufficient to impose tax liability.[55] Secondly, relying on *Behrend* and *Carrington*, the court held that the absence of any obligation on the part of taxpayer's corporation to redeem the stock when offered by the institution clearly refuted the Commissioner's contention that taxpayer's donations were the first steps in a prearranged series of transactions. Although it acknowledged that tax considerations played a significant role in taxpayer's planning, the court observed that taxpayer foresight is not a sufficient reason to impose tax liability. Moreover, it reasoned that the Commis-

51. 476 F.2d 704 (5th Cir. 1973).

52. *Id.* at 708.

53. *See* Sheppard v. United States, 361 F.2d 972, 977 n.9 (Ct. Cl. 1966).

54. The court did acknowledge, however, that the Commissioner might have argued that the portion of the redemption proceeds allocable to taxpayer's retained life interest was taxable as a dividend. Nevertheless, since the Commissioner did not raise this argument in the lower court, it found it would be inappropriate to consider the significance of the life interest in its discussion of the gifts. 490 F.2d at 246 n.9.

55. *Accord,* National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949).

sioner's application of the step-transaction doctrine would substitute two fictional transactions—a redemption from taxpayer by the corporation followed by taxpayer's gift to the institution—for two actual transactions—a gift by taxpayer to the institution followed by the corporation's redemption from the institution. The court concluded that the doctrine was not applicable, and consequently held that the redemption proceeds were not constructive dividends to taxpayer. The dissent[56] argued that the closely held nature of the corporation, the regularity with which the redemptions occurred,[57] and the retention of a life income interest[58] in the gift with substantial control over the reinvestment of the redemption proceeds were factors that justified application of the step transaction doctrine to impose tax liability; these factors combined to allow taxpayer a bail out of earnings and profits from his nondividend paying corporation. In concluding that the Commissioner's assessments should have been upheld, the dissent contended that both *Behrend* and *Carrington* were distinguishable because in those cases the taxpayer did not retain a life income interest nor was there a pattern of redemption as existed in the present case.

The significance of the instant decision lies in its effect on tax planning for majority stockholders whose assets consist primarily of close-corporation stock. Ordinarily a close-corporation shareholder interested in making a charitable contribution has the corporation redeem a portion of his stock and then he transfers the proceeds—reduced by any tax paid on the redemption—to the charity.[59] Under the procedure followed by taxpayer in the instant decision, however, the shareholder gains important tax advantages; the redemption is tax-free, he enjoys the benefits of financial diversification and a dependable source of income while retaining control over his nondividend-paying close corporation, and receives a charitable deduction for the remainder interest.[60] In addition, given the

56. 490 F.2d 241, 248 (Oakes, J., dissenting).

57. The dissent maintained that this sure expectation of redemption made the absence of a written agreement unimportant. *Id.* at 249.

58. The dissent noted that the educational institution's reinvestments of the redemption proceeds gave taxpayer a life interest in an entirely different sort of security than he had as owner of his close corporation's shares, thus accomplishing a financially desirable diversification and creating a dependable interest and dividend flow. *Id.*

59. *See Planning for Charitable Donations,* UNITED STATES TRUST (Monthly Rptr. Nov. 1973).

60. The instant decision was decided under law in effect prior to the Tax Reform Act of 1969 and therefore to qualify a gift of a remainder interest in property for the charitable deduction today taxpayer would have to make his donation in the form of an annuity trust, a unitrust, or a pooled income fund. *See* INT. REV. CODE OF 1954, §§ 170(f)(2), (3), 642(c), 664; Treas. Reg. §§ 1.170A-6, -7, 1.642(c), 1.664-2, -3 (1969).

decline in federal grants and corporate contributions to charitable and educational institutions,[61] the instant decision offers these institutions an attractive device to solicit contributions from individual stockholders of close-corporations. The extent to which the holdings provides a safe harbor is questionable, however, because of its inconsistency with the liquidation case, *Kinsey,* decided by the same court. In *Kinsey,* the court implicitly applied the step-transaction doctrine refusing to give any weight to the technical possibility that the liquidation plan could have been repudiated after the gift of stock was made. The *Kinsey* court focused on the economic reality of the transaction and found that the possibility of repudiation was vitiated by the potential adverse tax consequences to the shareholders, by the university's policy of systematically liquidating donated stock and by the taxpayer's intent.[62] Yet in the instant case the same court ignored the economically inescapable fact that sound fiscal policy dictated an offer of redemption of close corporation stock by the institution's treasurer and a reinvestment of the proceeds in income-producing securities of a less risky nature.[63] It is possible to justify the inconsistency between *Kinsey* and the instant decision on the ground that the donation of stock in the former occurred *after* the adoption of a liquidation plan thereby establishing a presumption that the donor intended to assign his income and not to donate an interest in a going corporation, whereas in the instant decision the taxpayer transferred the stock *before* a formal redemption plan was adopted. If the distinction between the two cases is in fact based upon the presence or absence of an express plan at the time of the gift, the two cases illustrate a trap for the unwary taxpayer. A taxpayer who contributes close-corporation stock to a charity after a plan of liquidation (redemption) has been adopted will find himself liable for an assignment of income. The well-advised taxpayer, however, can avoid tax liability by simply postponing his corporation's adoption of the liquidation (redemption) plan until after he has donated the stock to charity. There is a parallel between this trap and the situation that existed after the *Court Holding Co.* and *Cumberland* decisions. Just as Congress responded to the *Court Holding Co.-Cumberland* trap by enacting section 337, perhaps Congress should legislate in response to the trap created by *Kinsey*

61. *See* N.Y. Times, Oct. 18, 1973, at 73 col. 1.

62. *See* text of note 47 *supra.*

63. In addition, "[t]he stock was non-dividend-paying stock so that unless it was redeemed by the corporation after the transfer to the charity, the reserved right to income would [also] be meaningless." A. J. CASNER, ESTATE PLANNING 1622 (Supp. 1973).

and the instant decision. It would appear that there are two possible approaches such legislation could take. On the one hand, Congress could enact a statute which would provide for constructive dividend treatment for gifts of close-corporation stock if the stock is subsequently redeemed by the corporation pursuant to a *pre-gift* plan unless, by such a gift, the donor divests himself of control of his corporation. While this approach would be consistent with present dividend taxation policy and would reconcile *Kinsey* and the instant decision, nevertheless, by such an approach, Congress would be in effect "legislating the trap" by emphasizing the timing of the adoption of an express plan. On the other hand, Congress could enact a statute similar to section 337 which would permit the close-corporation shareholder to make a charitable donation of stock without regard to the timing of the adoption of an express plan. This approach would reflect a desire by Congress to encourage charitable gifts and would eliminate the present discrimination against close-corporation shareholders which exists in the charitable contribution area. As indicated above,[64] a gift of nondividend-paying close-corporation stock is valueless to an educational institution or charity unless the stock can be redeemed by the corporation or exchanged for liquidation assets—an event that, under *Kinsey*, may produce tax liability to the donor. A gift of public-issue corporation stock, however, provides the institution with a readily marketable, income-producing asset, which can be held by the donee with no necessity of redemption or liquidation.

In addition to this inconsistency with *Kinsey*, the instant decision's emphasis on correctly timing the adoption of an express plan illustrates another shortcoming; by holding that the redemption proceeds were not constructive dividends to the taxpayer the decision limits the scope of the step-transaction doctrine, whose application is called for when the substance of a transaction reveals the existence of a plan or obligation that is not readily apparent from the transaction's form. The instant decision is also distinguishable from the close-corporation stock-redemption cases upon which the majority heavily relied. In the Fourth Circuit's *Behrend* holding a crucial factor was that the taxpayer did not receive any post-gift benefits from the foundation.[65] The taxpayer in the instant case, however, received quarterly dividend payments from the institution's investment account. In contrast to the taxpayer in *Carrington*, the instant taxpayer did retain dominion and control over his

64. *See* note 63 *supra* and accompanying text.
65. *See* note 50 *supra* and accompanying text.

gift through his designation of the investment advisor to the university's account.[66] It is debatable whether the taxpayer's receipt of benefits in the form of quarterly dividend payments and his retention of some control over his gift justify taxing him as the recipient of the *full value* of the redemption proceeds. As the majority pointed out,[67] in future cases a more successful argument for the Commissioner might be that the taxpayer should be taxed as a constructive recipient of the redemption proceeds to the extent of the value of his retained life interest. Such an argument would be consistent with tax policy by preventing the tax-free bail-out of earnings and profits from a nondividend-paying close-corporation and it would be consistent with *Behrend* and *Carrington* by taxing the donor to the extent of his retained control over his gift and his receipt of benefits from the donee.

66. *Alumnus' Charitable-Giving Program Passes the Test,* 9 CCH 1974 STAND. FED. TAX. REP., Rewrite Bulletins (74-9 at 75, 456) ¶ 8264 (1974).

67. *See* note 54 *supra.*