Recent Cases

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Antitrust—Agency Franchise Agreements Are Reasonable Tradc Rcstraints Undcr Sherman Act While Restraints Following Sale Are Per Se Unlawful

The United States sought to enjoin defendant Arnold, Schwinn & Company's bicycle distribution system as an unlawful restraint of trade under section 1 of the Sherman Act.[1] Presumably to revitalize its declining market position and to meet the challenge of the increased sales activities of giant retailers,[2] Schwinn had introduced the challenged distribution system. It was composed of three separate plans: under the first arrangement the bicycles were sold outright to the wholesalers; the second plan consisted of sales to retailers under agency or consignment arrangements; and under the third arrangement, designated the "Schwinn Plan," the defendant shipped directly to retailers, extended credit to and collected from the retailers, and paid a commission to the distributor who took the order. Under each arrangement, the franchised wholesalers and retailers were subject to territorial and customer restrictions on their distribution practices.[3] The Government contended that these restrictions significantly reduced intrabrand competition. The defendant argued that the anticompetitive effect on intrabrand competition was reasonable in that it promoted more vigorous interbrand competition.[4] The district court held that the territorial limitations, but not the customer restraints, respecting products sold outright by Schwinn to distributors and retailers were unlawful per se, but that the restrictions regarding consignment and agency arrangements were reasonable restraints on trade.[5] On direct appeal[6] to the United States Supreme Court, *held*,

1. 26 Stat. 209 (1890), *as amended*, 15 U.S.C. § 1 (1964): "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. . . ."

2. Schwinn, which in 1951 had the greatest share of the bicycle market—22.5%, had declined to 12.8% by 1961, largely because of increased sales activities by giant retailers, which accounted for over 60% of all bicycle sales to consumers in 1961. Two firms—Sears, Roebuck & Co. and Montgomery Ward & Co.—accounted for 20% of all sales.

3. Each retailer was franchised only as to a designated location and was to purchase only from or through the distributor serving that area. Each retailer was prohibited from selling Schwinn products to unfranchised dealers. While a franchised dealer was not prohibited from handling competing brands, the agreement stipulated that Schwinn bicycles were to be equally promoted with other brands.

4. Schwinn argued that the restraints were ancillary to a reasonable promotion of its competitive position vis-à-vis other competing brands.

5. United States v. Arnold, Schwinn & Co., 237 F. Supp. 323 (N.D. Ill. 1965).

6. Appeal was brought under § 2 of the Expediting Act, 15 U.S.C. § 29 (1964).

reversed. Territorial and customer restrictions by a manufacturer on distributors and retailers incident to consignment or agency agreements are lawful where the manufacturer's market position is being eroded by giant competitors, whereas similar restrictions following sale by the manufacturer are per se violations of the Sherman Act.[7] *United States v. Arnold, Schwinn & Co.*, 388 U.S. 365 (1967).

Although before 1950 courts generally upheld territorial and customer restrictions imposed by manufacturers on their franchises,[8] the Justice Department began to attack these arrangements on the theory that such vertical restrictions have the same anti-competitive effects as concededly unlawful horizontal agreements among dealers and that therefore they should be declared per se illegal.[9] But the Supreme Court, in *White Motor Co. v. United States*,[10] seemed unwilling to accept the Government's position and chose to postpone the matter until more evidence had been presented.[11] There the defendant manufacturer, allegedly to improve its unstable position in the market, sold its product only to dealers who had signed contracts containing territorial and customer limitations. The Court noted that under some circumstances purely vertical territorial and customer restraints which lead primarily to a lessening of intrabrand competition could be justified because they would enable the firm to compete more successfully against other firms, whereas purely horizontal restraints which lead to curtailing of interbrand competition could not.[12] In a con-

7. The Supreme Court agreed with the district court that vertical territorial and customer restrictions on distributors and retailers incident to consignment and agency agreements were unlawful only if unreasonable, and that vertical territorial restrictions following outright sale by a manufacturer were per se violations of the Sherman Act, but added customer limitations incident to an outright sale were also a per se violation.

8. *E.g.*, Cole Motor Car Co. v. Hurst, 228 F. 280 (5th Cir. 1915), *aff'd sub nom.* Tillar v. Cole Motor Car Co., 246 F. 831 (5th Cir. 1917), *cert. denied*, 247 U.S. 511 (1918); Phillips v. Iola Portland Cement Co., 125 F. 593 (8th Cir. 1903), *cert. denied*, 192 U.S. 606 (1904). The Justice Department relied on a dictum in United States v. Bausch & Lomb Optical Co., 321 U.S. 707, 721 (1944): "A distributor of a trademarked article may not lawfully limit by agreement, express or implied, the price at which or the persons to whom its purchaser may resell . . . . The same thing is true as to restriction of customers." (unlawful price-fixing contaminates entire distribution system including customer restrictions).

9. There have been numerous consent decrees. *E.g.*, United States v. Rudolph Wurlitzer Co., 1958 Trade Cas. ¶ 69,011 (W.D.N.Y.); United States v. J. P. Seeburg Corp., 1957 Trade Cas. ¶ 68,613 (N.D. Ill.); United States v. Philco Corp., 1956 Trade Cas. ¶ 68,409 (E.D. Pa.).

10. 372 U.S. 253 (1963).

11. "A vertical territorial limitation may or may not have [an anti-competitive] purpose or effect. We do not know enough of the economic and business stuff out of which these arrangements emerge to be certain." *Id.* at 263.

12. Vertical territorial restrictions tend to eliminate competition among distributors or dealers of a single product within the distributor's or dealer's own area. Since the particnlar outlet is protected from competition, it can, once it becomes established, exercise a substantial amouut of monopoly power in the area. Vertical customer restrictions tend to keep prices up by preventing goods from getting into the hands

curring opinion, Mr. Justice Brennan sought to spell out some of these circumstances. He suggested that vertical limitations might be reasonable if the firm were either failing or marketing a risky product or if it were a new entrant in the market. Since the *White Motor* decision, the lower courts have sustained the validity of similar vertical restrictions. In one case[13] the Sixth Circuit upheld territorial and customer restrictions of a financially unstable corporation which allegedly needed the restrictions to induce dealers to market its products. The Seventh Circuit took a bolder stance in upholding territorial restrictions by an established company,[14] but noted that "bloody competition" in the market could drive the company out of business. At the same time that the boundaries of *White Motor* were being delineated, manufacturers established agencies and consignment systems with a view to achieving vertical restrictions without violating the antitrust laws.[15] However, the Supreme Court, in *Simpson v. Union Oil Co.*,[16] appeared to preclude this approach by indicating that if the practices violated the antitrust law, they would be enjoined regardless of the form used.

Speaking for the majority in the instant case, Mr. Justice Fortas noted that when "a manufacturer parts with title, dominion, or risk with respect to the article,"[17] all restrictions—territorial or customer—are "in the nature of restraints on alienation"[18] and therefore per se unlawful agreements in restraint of trade. The Court revised the

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of discount houses. Yet it may be possible to justify these restrictions. Vertical restraints may tend to promote competition in the market as a whole, by strengthening one competitor's ability to compete against others (*i.e.*, interbrand competition). Furthermore, the more nearly identical the products of other brands are, the lesser the anti-competitive effects on the entire market. In contrast, horizontal restrictions—being agreements among manufacturers *or* dealers to divide markets among themselves—tend to cut down on competition between different brands, thus producing an anti-competitive effect on the market as a whole. For an economically oriented study of vertical distribution restrictions, see Note, *Restricted Channels of Distribution Under the Sherman Act*, 75 HARV. L. REV. 795 (1962).

13. Sandura v. FTC, 339 F.2d 847 (6th Cir. 1964).

14. Snap-On-Tools v. FTC, 321 F.2d 825 (7th Cir. 1963). Snap-On distributed through independent, territorially franchised dealers who sold on designated routes out of mobile, walk-in trucks, most of which were owned by the dealers. When expensive equipment was desired, Snap-On's salesmen rented or leased the equipment and made collections for Snap-On. The relationship in this case, then, closely approximated employment and was probably influential in persuading tho Seventh Circuit to take a bolder stand.

15. The manufacturers relied on dictum in Standard Oil Co. v. United States, 337 U.S. 293, 310 (1949): "Before the system of requirements contracts was instituted, Standard sold gasoline through independent service-station operators as its agents, and it might revert to this system if the judgment below were sustained."

16. 377 U.S. 13 (1964). *Simpson* has been followed in a reeent case. Guidry v. Continental Oil Co., 350 F.2d 342 (5th Cir. 1965).

17. 388 U.S. at 378-79.

18. *Id.* at 377.

district court's decree to also include wholesaler restrictions relating to sold goods, enjoining arrangements which prohibited the resale of bicycles to unfranchised retailers.[19] But the majority refused to extend the decree to enjoin all territorial and customer restrictions however effected. Refusing to apply an inflexible per se standard to the restrictions effected through agency or consignment, or through the "Schwinn Plan," Mr. Justice Fortas affirmed the district court's conclusion that these restrictions on franchised distributors and retailers were reasonable "in view of the competitive problem presented by 'giant' bicycle retailers."[20] He emphasized that since other reasonably interchangeable brands of bicycles were readily available both in the market generally and through Schwinn distributors and retailers, interbrand trade was not unreasonably restrained. The majority concluded that Schwinn's intrabrand restrictions were made necessary by the competitive situation, went no further than that situation required, and were designed to promote, rather than hinder, competition.[21]

In reaffirming the distinction drawn in the *White Motor* case between the anti-competitive effects of vertical and horizontal restrictions, the Court correctly sought to find permissible bounds within which manufacturers might control the activities of their distributors. The instant holding sets new criteria for the "reasonableness" of such control: vertical restraints on agents can be reasonable if the manufacturer's declining position needs a "boost," or if the manufacturer is trying to protect his "good will" in the face of vigorous competition from large firms; vertical restraints on independent dealers are never reasonable. The Court implied that even a failing company or a new entrant into the market cannot place a restraint on alienation on the products which it sells rather than consigns to independent distributors and retailers. On the other hand, companies can impose vertical restraints on agents even when the company is neither failing nor a new entrant. Schwinn, though declining, was neither new nor

19. The Court declared that "it is illogical and inconsistent to forbid territorial limitations on resales by distributors where the distributor owns the goods . . . and, at the same time, to exonerate arrangements which require distributors to confine resales of the goods they have bought to 'franchised' retailers." *Id.*

20. *Id.* at 376.

21. At the trial, the element of "good will" was crucial to the district court. The only way Schwinn could compete with giant retailers, to whom it refused to capitulate, was to develop a reputation of reliable service attached to the Schwinn label. The district court was persuaded by testimony that Schwinn's pre-1952 distribution program was inefficient and expensive. In part because of this, Schwinn's sales were declining. Schwinn made a survey of more efficient distributing schemes, which showed that many of the retail outlets were no longer in existence and that more than half of the bicycles sold by Schwinn were sold to bicycle shops which provided parts and reliable service. 237 F. Supp. 323, 337 (1965).

failing, nor was its product risky.[22] Yet its restrictions on its "agents" were held reasonable. It is unclear, however, why the Court chose to rely on this agency-sale distinction, thus defining the boundaries on the basis of a legal relationship which is of limited value for antitrust purposes. As Mr. Justice Stewart noted in a separate opinion, dissenting in part, the majority relied more on the district court's findings than on economic analysis. He also pointed out that Schwinn's policy of "ensuring that only franchised retailers would be supplied with its products" was furthered equally under a sales or an agency agreement. By merely redrafting the agreement, all of Schwinn's retailers would become "agents" and all the shipments to them would be "consignments." The record did not show, Mr. Justice Stewart argued, that the restrictions incident to a sale were more anti-competitive and less justifiable than the "Schwinn Plan" restrictions.[23] By its decision, the Court has opened the possibility of allowing greater anti-competitive practices under an agency device than had been allowed before the distinction was made. To do so would lose sight of the underlying antitrust policy while looking only to a doubtful technical distinction. A more satisfactory approach would have been for the Court in the instant case to have followed the *White Motor* decision and to have determined the reasonableness of the vertical restrictions, however effected.

Antitrust—Product Extension Merger in Violation of Section 7 of the Clayton Act

The Federal Trade Commission challenged the 1957 acquisition of Clorox Chemical by Procter & Gamble as a violation of section 7 of the Clayton Act.[1] Prior to the merger, Clorox was the nation's largest producer of household liquid bleach, accounting for almost forty-nine per cent of sales in the industry.[2] The bleach industry was

22. Although in 1961 Schwinn's share of the market had fallen, its dollar and unit sales had risen substantially.

23. Mr. Justice Stewart also contended that no previous decision justified the new application of the per se rule. In fact, he felt that the instant decision overruled the *White Motor* case.

1. 15 U.S.C. § 18 (1964). The first and principal paragraph reads: "No corporation engaged in commerce shall acquire, directly or indirectly, the whole or any part of the stock or other share capital and no corporation subject to the jurisdiction of the Federal Trade Commission shall acquire the whole or any part of the assets of another corporation engaged also in commerce, where in any line of commerce in any section of the country, the effect of such acquisition may be substantially to lessen competition, or to tend to create a monopoly."

2. Clorox had been increasing its share of the market almost one per cent annually since 1953, and after the merger its market share eventually increased to 52%.

highly oligopolistic, with the six top firms accounting for almost eighty per cent of market sales.[3] Procter, the largest producer of soap, detergents and related household products, had assets of over half a billion dollars, and as the nation's largest advertiser, received substantial discounts from the various advertising media.[4] The Commission found that the cumulative effects of the merger were a violation of section 7 of the Clayton Act and ordered divestiture.[5] The Court of Appeals for the Sixth Circuit reversed. On certiorari to the United States Supreme Court, *held*, reversed and remanded. The acquisition of a smaller company, which produces a functionally related product[6] and is dominant in its oligopolistic product market, by a large, diversified firm which had previously been a potential entrant into the market, may substantially lessen competition and is thus a violation of section 7 of the Clayton Act. *Procter & Gamble Co. v. FTC,* 386 U.S. 568 (1967).

When Congress amended section 7 of the Clayton Act in 1950, one of its main purposes was to make the law clearly applicable "to all types of mergers and acquisitions, vertical and conglomerate as well as horizontal, which have the specified effects of substantially lessening . . . competition or tending to create a monopoly . . . ."[7]

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3. Entry into small local markets was relatively easy, as the existence of over 200 small firms, few with assets of over $75,000 attests. However, the bleach industry was deemed oligopolistic hecause entry into the national and regional markets was cxtremely difficult and cxpensive since a bleach manufacturing plant could only serve a 300 mile radius economically due to the low price of bleach and large advertising expenditures which were necessary to successfully market a brand. *See* note 30 *infra* for a discussion of the importance of advertising.

4. In 1957, Procter spent more than $80,000,000 ou advertising and an additional $47,000,000 on sales promotions, and was able to secure 25 to 30% quantity discounts on its television advertising. It should be noted that Procter no longer secures a discount from the broadcasting networks.

5. In 1960, the hearing examiner ruled against the merger; in 1961, the FTC remanded the case for post-acquisition evidence; in 1962, the examiner repeated his finding; and in 1963, the FTC (with only one member remaining from 1961) sustained the examiner, giving little weight to the post-acquisition evidence. Procter & Gamble Co., [1963-1965 Transfer Binder] TRADE REG. REP. ¶ 16,673. The FTC's opinion contained 85 citations to 43 economic, social and political writings not in the record, and included almost all the arguments made by economists that the conglomerate mergers would damage competition. Procter & Gamble Co. v. FTC, 358 F.2d 74 (6th Cir. 1966).

6. Packaged detergent, Procter's most important product category, and household liquid bleach are used complementarily on wash day. Thus, from the consumer's viewpoint, the two products are closely related. Also, household liquid cleansing agents in general and household liquid bleach, are generally low-cost, high-turnover consumer goods marketed chiefly through grocery stores and in large part pre-sold to the consumer by the mass advertising and sales promotions of the manufacturer. Consequently, the possibility of significant integration at both the marketing and distribution level arises since the products are sold to the same customers, at the same stores, and by the same merchandising methods.

7. H. R. REP. No. 1191, 81st Cong., 1st Sess. 11 (1949).

In *Brown Shoe Co. v. United States*[8] the Supreme Court viewed this amendment as indicating a "congressional concern with the protection of *competition,* not *competitors,* and . . . [the congressional] desire to restrain mergers only to the extent that such combinations may tend to lessen competition."[9] The *Brown Shoe* decision[10] was generally regarded as a determination of the validity of a merger under section 7 by an analysis of all the relevant economic data pertaining to the market situations.[11] In *United States v. Philadelphia Nat'l Bank,*[12] the Court reasoned that a "too broad" application of this type of analysis in cases in which the economic data relating to the structure of the relevant market is "complex and elusive" may frustrate the purpose of section 7 and lead to a lack of confidence in business planning.[13] The Court stated that in certain cases the "intense congressional concern with the trend toward concentration warrants dispensing . . . with elaborate proof of market structure, market behavior, or probable anticompetitive effects." The Court held that mergers producing a firm which has control over an "undue percentage" of the relevant market and resulting in a significant increase in concentration in the market must be enjoined in the absence of evidence clearly showing that the merger is not likely to have such anticompetitive

8. 370 U.S. 294 (1962). This was the first case which required extensive analysis of amended section 7. Only two prior decisions by the Court were based upon amended section 7, but neither case required an authoritative interpretation of the section. Jerrold Electronics Corp. v. United States, 365 U.S. 567 (1961), *opinion below,* 187 F. Supp. 545 (E.D. Pa. 1960); Maryland & Virginia Milk Producers' Ass'n, Inc. v. United States, 362 U.S. 458 (1960).

9. Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962).

10. Brown controlled 4% of the national market for men's, women's, and children's shoes. In addition it also controlled some 1230 retail outlets or between 6 and 7% of the shoe stores in the country. Although Kinney accounted for only 0.5% of domestic shoe production, this combination made Brown the nation's largest shoe producer, controlling from 5.1 to 57.7% of the retail market for women's shoes and from 5.1 to 24.8% of the men's shoe market, in various communities.

11. Bock, *The Relativity of Economic Evidence in Merger Cases—Emerging Decisions Force the Issue,* 63 Mich. L. Rev. 1355, 1357 (1963). This approach has been called the rule-of-reason standard. However, the true rule-of-reason standard employs a case-by-case (ad hoc) analysis of all relevant economic and structural factors with a view toward the determination of the probable economic consequeuces of a merger. Comment, *Clayton Section 7: A Critical Appraisal of the Supreme Court's Anti-trust—Anti-bigness Complex in Merger Litigation Since the Brown Shoe Case,* 11 Wayne L. Rev. 739, 754 (1965). Although the *Brown Shoe* approach has merit because of its flexibility, it requires a wide open record and a heavy drain on court time and the defendant's finances. In addition, this test fails to indicate the relative weight to be given to each factor and provides no real degree of predictability. Hrusoff, *Conglomerate Mergers, Joint Ventures, Market Extensions and Section 7 of the Clayton Act,* 69 Dick. L. Rev. 113 (1965).

12. 374 U.S. 321 (1963). The Court invalidated the merger between the second and third largest of Philadelphia's 42 commercial banks. The decisive figures were that 30% of the commercial banking business would be obtained by the merging banks, and 59% (up from 44%) by the two largest. *Id.* at 364-65.

13. *Id.* at 362.

effects.[14] Thus, *Philadelphia Nat'l Bank* developed a mechanical test which placed emphasis on market concentration as the key to an assessment of a merger's validity. This test was applied in *United States v. Aluminum Co. of America*[15] and *United States v. Continental Can Co.*,[16] where the Court largely ignored the economic evidence presented by the parties, and concentrated on the structural aspects of the market.[17] In *United States v. Von's Grocery Co.*[18] the Court in effect concluded that any merger between large firms in a market characterized by a continuous trend toward fewer competitors would be a per se violation of section 7.[19] And, in *United States v. El Paso Natural Gas Co.*[20] the court held that a merger eliminating even a potential competitor from the market might violate section 7. Two rules seem to be emerging: first, where concentration is already great, even slight increases must be prevented; and second, where there is a strong trend toward oligopoly, further tendencies in that direction are to be curbed in their incipiency, whatever the number or vigor of the competitors.[21] Although the Supreme Court has placed increasing if not decisive weight on the share of the relevant markets controlled by the acquiring and acquired companies when vertical[22] or horizontal[23] mergers are involved, authorities have argued that such an

14. *Id.* at 363.

15. 377 U.S. 271 (1964). The Court invalidated the acquisition by Alcoa of the Rome Cable Corporation. Alcoa manufactured aluminum conductor and Rome produced copper conductor.

16. 378 U.S. 441 (1964). The Court declared Continental Can's (the second largest producer of metal containers) acquisition of the Hazel-Atlas Glass Company (the third largest producer of glass containers) in violation of section 7.

17. Note, *The ABC's of Clayton 7: Amendment of 1950; Brown Shoe; The Court and Current Complexities*, 10 VILL. L. REV. 734, 757 (1965).

18. 384 U.S. 270 (1966). The Court declared the merger of Von's, which had 4.7% of the Los Angeles grocery market and ranked third, with Shopping Bag which ranked sixth with 4.2% invalid. The merger of two major competitors in an industry marked by a long and continuous trend toward concentration was said to violate section 7 of the Clayton Act.

19. Some writers have observed that there has been an increasing tendency to find a probable lessening of competition whenever there is a possibility of injury to a competitor. Rill, *The Trend Toward Social Competition under Section 7 of the Clayton Act*, 54 GEO. L.J. 891, 898-99 (1966). Although the Court has repeatedly stated that it protects competition rather than competitors, its decision in Von's Grocery indicates that the Court actually equates an increased number of competitors with increased competition.

20. 376 U.S. 651 (1964). The Court overruled the Federal Power Commission's approval of the merger of El Paso Natural Gas with Pacific Northwest Pipeline. Pacific Northwest did not operate in California, but it was seeking ways to enter this expanding market. The decision against the merger rested on the fact that there was a good chance it would enter the market in competition with El Paso.

21. Singer, *The Concept of Relative Concentration in Antitrust Law*, 52 A.B.A.J. 246, 248 (1966).

22. Vertical merger is defined as an acquisition of the stock or assets of a firm that buys the product sold by the acquirer or sells a product bought by the acquirer.

23. Horizontal merger is defined as an acquisition by a firm of the stock or assets

approach would be of little value in determining the validity of a conglomerate merger under section 7.[24] Conglomerates, which have been defined as including all mergers except horizontal and vertical mergers, are generally classified into three groups: (1) "pure conglomerates" in which there are no discernible economic relationships between the business of the acquiring and of the acquired firms; (2) "market-extension" mergers involving the acquisition of a firm producing the same product as the acquired but selling it in a different geographic market; and (3) "product-extension" mergers which involve the acquisition of a company manufacturing a different product which is nevertheless related to a product or products of the acquiring firm.[25] The possible anticompetitive effects of conglomerate mergers have been discussed by numerous economic and legal writers,[26] but heretofore the Court has not examined the anticompetitive consequences of such mergers.[27]

In the instant case the Court noted that since it is the purpose of section 7 to arrest anticompetitive effects upon the market in their incipiency it must be the probability, rather than the actual manifestation of substantial anticompetitive effects of a merger, which violates section 7. The Court further noted that *all* mergers, whatever their nature, are governed by the same standard—the words of section 7. Because these firms were producing functionally related products, the Court labelled this a "product-extension" merger. The Court then adopted the reasoning of the Commission in declaring that Procter's entry into the bleach industry by merger, rather than internal expansion, presented potential injury to competition in three ways. The competitive structure of the oligopolistic bleach industry[28] may have been substantially impaired because of the probability that Procter would become the price leader in the market and that the oligopoly would thus become more rigid.[29] The Court further rea-

of another firm producing an identical product or close substitute and selling it in the same geographical market.

24. Turner, *Conglomerate Mergers and Section 7 of the Clayton Act*, 78 HARV. L. REV. 1313, 1316 (1965). Professor Donald F. Turner was appointed Chief of the Antitrust Division of the Department of Justice in 1965, and assisted in the preparation of the government's brief in the instant case.

25. Professor Turner labels "product-extension" and "market-extension" mergers as mixed conglomerates, and recognizes that the conglomerate grouping contains situations analytically quite dissimilar. *Id.* at 1314-15.

26. *See* note 5 *supra.*

27. Prior to the decisions in United States v. Aluminum Co. of America, 377 U.S. 271 (1964), and United States v. Continental Can Co., 378 U.S. 441 (1964), it was generally assumed that these cases involved conglomerate mergers. However, the relevant product market was so defined that the mergers were classified as horizontal rather than conglomerate; thus making a discussion of conglomerates unnecessary.

28. *See* note 3 *supra.*

29. 386 U.S. 568, 576-77 (1967).

soned that because advertising is so important to the successful marketing of bleach,[30] the merger may serve as a barrier to entry into the bleach industry, since a new entrant would be much more reluctant to face the giant Procter, which could divert part of its large advertising budget to meet the short term threat of such an entry. The Court also stated that the merger would seriously diminish potential competition by eliminating Procter as a potential entrant into the bleach industry. The Court reasoned that prior to the merger, Procter was the most likely entrant into the bleach industry, and absent the merger would have remained on the periphery as an independent competitive force, restraining Clorox from exercising its market power.[31] Citing *Brown Shoe*, the Court stated that the possible economies in advertising and other areas which could have resulted from the merger were no defense to its potential anticompetitive effects.[32] Thus the Court held that the Commission's decision was supported by substantial evidence and remanded the case to the court of appeals for enforcement of the Commission's order of divestiture. Mr. Justice Harlan, concurring, agreed with the criteria utilized by the Court in reaching its decision, but felt that an analysis of all the relevant economic data was necessary in order to determine the legality of the merger, and concurred after such an analysis.[33]

In the instant case, the Supreme Court engaged in its first full consideration of the legality of a product-extension merger. Guidelines had previously been established for vertical and horizontal mergers, but the narrow scope of the boundaries of legality in such mergers has caused the business community to turn increasingly to con-

30. The FTC found that Clorox's expenditures, of almost \$3.7 million on advertising and \$1.7 million on other promotions in 1957, to imprint the value of its bleach in the minds of the consumer, went far to explain why it maintained such a high market share despite the fact that its brand, though chemically indistinguishable from rival brands, retailed at prices equal to or greater than its competitors.

31. Procter was engaged in a vigorous program of diversification into product lines closely related to its basic products, and liquid bleach was a natural avenue for expansion. The Court found that the existence of Procter at the edge of the industry exerted a considerable influence on the market, since the market behavior was influenced by each firm's predictions of the market behavior of its real and potential competitors, and that the barriers to entry by a firm of Procter's size and advantages were not significant. Also, the number of potential entrants was not so large that the elimination of one would be significant.

32. As a multi-product producer, Procter enjoys substantial advantages in advertising and sales promotions. It can and does feature several products in its promotions, reducing the printing, mailing and other costs for each product. It also purchases network programs on behalf of several products, enabling it to give each product network exposure at a fraction of the cost per product that a single-product firm would incur. For a good discussion of the relevancy of advertising economies as a basis for determining the legality or illegality of a conglomerate merger, see Turner, *supra* note 24, at 1332-39.

33. Mr. Justice Harlan also said that the Court's opinion fails to fix standards and leaves the FTC, lawyers and businessmen in a state of doubt as to what is to be expected of them in future conglomerate merger cases.

glomerates as a means of expansion.[34] The lack of guidelines for application in challenged conglomerate mergers has proved a source of difficulty for both the Federal Trade Commission[35] and the lower courts.[36] By its decision in *Procter*, the Court has enumerated criteria to be applied in ruling on a "product-extension" form of conglomerate merger.[37] Among the factors to be considered are the barriers to entry that the acquisition would raise, the anticompetitive effects of the elimination of the acquiring firm as a potential entrant, the dominance the acquired firm exerts in its product market, and the structure of the relevant markets. However, continuing the trend established in *Philadelphia Nat'l Bank*, the Court rejected the need for elaborate proof of the probable anticompetitive effects of the merger. Thus, the Court intimated that there was an *inherent probability* that the substitution of such a powerful firm as Procter for the already dominant Clorox could only have an injurious effect on the competing firms in the bleach industry. Yet, in dismissing the need for a full-scale examination of relevant economic data and by regarding instead the inherent probability of anticompetitive effects, the Court failed to establish standards as to the size of the acquiring firm, the dominance of the acquired, or the status of the market structure necessary to invalidate a product-extension conglomerate merger. By the Court's failure to delineate the precise boundaries of legality, considerable uncertainty remains as to the power of the antitrust laws to invalidate pure conglomerate mergers.[38] Considering the Court's present disposition toward fragmented markets,[39] it is perhaps possible that some of the arguments asserted by the instant Court may be employed against

34. Comparing 1948-1953 with 1960-1964, horizontal mergers decreased from 31% to 12% of the total of 811 large mergers (acquisitions of companies with assets of $10,000,000 or more), while vertical mergers increased from 10% to 17%, and conglomerates from 59% to 71%. A breakdown of conglomerates into three classes shows "market-extension" mergers unchanged at 7%, "product-extension" mergers increasing from 47% to 53%, and all others (pure conglomerates) increasing from 5% to 11%. Whitney, *Mergers, Conglomerates, and Oligopolies: A Widening of Antitrust Targets*, 21 RUTGERS L. REV. 187, 194 (1967).

35. The author of the FTC's exhaustive opinion in *Procter* later explained that the opinion was elaborate because the Commission was aware that it was entering uncharted territory, General Foods Corp., 2 (1967 Transfer Binder) TRADE REG. REP. ¶ 17, 465 (Commissioner Elman, dissenting, at ¶ 22,745).

36. *E.g.*, Ekco Prods. Co. v. FTG, 347 F.2d 745 (7th Cir. 1965).

37. These factors, along with others, had been suggested by Professor Turner for utilization in determining the validity of conglomerate mergers. Turner, *supra* note 24.

38. Government officials have recently hinted at more suits against conglomerate mergers, especially product-extension mergers, while indicating a lack of power to attack pure conglomerate mergers. Wall St. J., Oct. 20, 1967, at 1, col. 5.

39. *See* United States v. Philadelphia Nat'l Bank, 374 U.S. 321, 365 n.42 (1963). Footnote 42 reads: "if concentration is already great, the importance of preventing slight increases in concentration and preserving the possibility of eventual deconcentration is correspondingly great." *See also* United States v. Von's Grocery Co., 384 U.S. 270, 275 nn.10 & 11 (1966), *noted in* 19 VAND. L. REV. 1373 (1966).

the pure conglomerates. Although the removal of the acquiring firm as a potential entrant into the market would not be a relevant consideration in pure conglomerate situations, such factors as the size[40] of the acquiring firm, the dominance the acquired firm exerts in its product market, the status of the market structure of this market and the consequent barriers to entry that the acquisition would raise would seem to be as relevant and material in pure conglomerate cases as in product-extension situations.[41]

Constitutional Law—Reapportionment—Principle of "One Man, One Vote" Not Applicable to Appointed County School Board Performing Administrative Function

Plaintiffs, qualified and registered voters of Kent County, Michigan, instituted an action for declaratory and injunctive relief[1] challenging the constitutionality of a Michigan statute pertaining to the composition of county school boards. Under this statute the county board members were chosen by delegates selected from locally elected boards in each school district within the county, one delegate from each local unit participating in the selection of the county board.[2] Citing the gross population imbalance between the various voting districts which possessed identical unit votes,[3] plaintiffs contended that this method of choosing the county board violated their rights to equal protection under the fourteenth amendment in that it failed to

40. *See* note 4 *supra* and accompanying text.

41. In General Foods Corp. v. FTC, TRADE REG. REP. (1967 Trade Cas.) ¶ 72,268, at 73,661 (3d Cir. Nov. 9, 1967), the Third Circuit held that the merger of General Foods with S.O.S. was a violation of § 7 of the Clayton Act. The same factors which were present in *Procter* were present in this case, with the exception that General Foods was not a potential competitor of S.O.S.

1. The dispute arose when the streets on which plaintiffs resided were annexed to the city of Grand Rapids, and, as a result, plaintiffs' properties were also transferred to the Grand Rapids school district. The school district in which plaintiffs had previously resided then petitioned the defendant board to nullify the transfer and return these properties to its jurisdiction. Over plaintiffs' objection, the defendant board granted the petition. Plaintiffs asked that the court set aside certain transfers of schools from one district to another and to enjoin the board from holding further elections until the imbalance in misrepresentation was cured.

2. Sailors v. Board of Educ., 387 U.S. 105, 109-10 n.6 (1967). The delegate's choice need not be responsive to the desires of the local electorate and in fact the delegate has no way of knowing what the preferences of the local electorate are.

3. The population variance in Kent County (with each board exercising a one unit vote) ranges from Nelson School District with a population of 99 to Grand Rapids with a population of over 201,000.

comply with the "one man, one vote" principle. Defendants contended that the principle did not apply to a local administrative[4] board and that the district court could not retain jurisdiction of the complaint's subject matter. By a divided vote a three judge court refused to declare the statute unconstitutional and dismissed the complaint.[5] On appeal to the United States Supreme Court, *held*, affirmed. The principle of "one man, one vote" is not applicable to a local governing body which performs essentially administrative functions, and is chosen by means of an essentially appointive, rather than elective process. *Sailors v. Board of Education*, 387 U.S. 105 (1967).

In *Baker v. Carr*,[6] the United States Supreme Court held the apportionment of voting districts in statewide elections to be a question justiciable in nature under the equal protection clause of the fourteenth amendment. This authority has provided the basis for various subsequent decisions[7] culminating in *Reynolds v. Sims*[8] where the Court held that the "one man, one vote" principle is applicable to all statewide legislative offices. However, neither *Reynolds* nor its progeny[9] have indicated whether the principle extends to local governmental bodies. Consequently, confusion has developed in both state and federal courts as to the propriety of extending the *Reynolds* doctrine to the local level.[10] Following the *Reynolds* decision, the

4. MICH. STAT. ANN. § 15.3298(1) (Supp. 1965). The authority of the county board includes: the appointment of a county school superintendent; preparation of an annual budget and levy of taxes; distribution of delinquent taxes; furnishing consulting or supervisory services to a constituent school district upon request; conducting cooperative education programs on behalf of constituent school districts which request such services, and with other intermediate school districts; employment of teachers for special education programs; establishing, at the direction of the Board of Supervisors, a school for children in the juvenile homes; and the power to transfer areas from one school district to another.

5. Sailors v. Board of Educ., 254 F. Supp. 17 (1966). Judge Fox, in the dissenting opinion, argued that the county board of education was a "representative" body and, since the voting power of some voters was grossly diluted, the court could legitimately apply the "one man, one vote" standard.

6. 369 U.S. 186 (1962), overruling Colegrove v. Green, 328 U.S. 549 (1946), which held that voting district apportionment was a political question, and thus not a "case or controversy" as required by U.S. CONST. art. III, § 2.

7. Wesberry v. Sanders, 376 U.S. 1 (1964); Gray v. Sanders, 372 U.S. 368 (1963).

8. 377 U.S. 533 (1964). "[A]n individual's right to vote for state legislators is unconstitutionally impaired when its weight is in a substantial fashion diluted when compared with votes of citizens living in other parts of the State." *Id.* at 568.

9. *See, e.g.*, Lucas v. Forty-fourth General Assembly, 377 U.S. 713 (1964); Roman v. Sincock, 377 U.S. 695 (1964); Davis v. Mann, 377 U.S. 678 (1964); WMCA, Inc. v. Lomenzo, 377 U.S. 633 (1964).

10. For cases applying the principle, *see, e.g.*, Delozier v. Tyrone Area School Bd., 247 F. Supp. 30 (W.D. Pa. 1965); Bianchi v. Griffing, 238 F. Supp. 997 (E.D.N.Y. 1965); *vacated and remanded sub nom.* Board of Supervisors v. Bianchi, 387 U.S. 97 (1967); Seaman v. Fedourich, 16 N.Y.2d 94, 209 N.E.2d 778, 262 N.Y.S.2d 444 (1965); State *ex rel.* Sonneborn v. Sylvester, 26 WIS. 2d 43, 132 N.W.2d 249 (1965). *Contra*, Moody v. Flowers, 256 F. Supp. 195 (M.D. Ala. 1966), *vacated and remanded*, 387 U.S. 97 (1967); Johnson v. Genesee County, 232 F. Supp. 567 (E.D. Mich. 1964).

problem has been encountered by courts which have extended the *Reynolds* principle. These decisions with few exceptions[11] have dealt with patently legislative bodies such as city councils and county boards of supervisors.[12] In cases involving governmental bodies with limited legislative powers[13] or primarily administrative[14] functions, the courts have adopted conflicting positions regarding the application of the *Reynolds* principle. An Alabama district court refused to apply the *Reynolds* principle in the case of *Moody v. Flowers*,[15] since the Supreme Court had not as yet extended *Reynolds* to local governing bodies, and held that the equal protection clause of the fourteenth amendment does not demand that local governmental units that have limited powers be elected from districts which are apportioned on a population basis. In *Strickland v. Burns*[16] another district court rejected the argument that the *Reynolds* principle does not extend to purely administrative bodies and applied the "one man, one vote" doctrine to a county school board, classifying it as a subordinate body possessing powers which cannot be held as insignificant. The court stated that the prohibition of invidious discrimination by *Reynolds* is as applicable to representative governmental bodies on the local level as to bodies on the state level.[17] The court determined that there was no basis for denying application of *Reynolds* to a subordinate body simply because its powers were limited.

Courts applying the legislative-administrative distinction have not been confronted with the argument that an appointive body, legislative in nature, is required by the constitution to be elected. Thus far the Supreme Court has not determined whether a state may constitute a local legislative body through the appointive as opposed to the

11. *See* Strickland v. Burns, 256 F. Supp. 824 (M.D. Tenn. 1966); Delozier v. Tyrone Area School Bd., 247 F. Supp. 30 (W.D. Pa. 1965).

12. *See, e.g.*, Ellis v. Mayor and City Council, 352 F.2d 123 (4th Cir. 1965); Bianchi v. Griffing, 238 F. Supp. 997 (E.D.N.Y. 1965); Miller v. Board of Supervisors, 63 Cal. 2d 343, 405 P.2d 857, 46 Cal. Rptr. 617 (1965); Hanlon v. Towey, 142 N.W.2d 741 (Minn. 1966).

13. If the governing body is non-legislative in character, then it would seem that the mandate of *Reynolds* would not apply, for as the Supreme Court held in that case, "Political subdivisions of States—counties, cities, or whatever—never were and never have been considered as sovereign entities. Rather, they have been traditionally regarded as subordinate governmental instrumentalities created by the State to assist in the carrying out of state governmental functions. . . . [T]hese governmental units are 'created as convenient agencies for exercising such of the governmental powers of the State, as may be entrusted to them,' and the 'number, nature and duration of the powers conferred upon [them] . . . and the territory over which they shall be exercised rests in the absolute discretion of the State.'" 377 U.S. at 577.

14. Strickland v. Burns, 256 F. Supp. 824 (M.D. Tenn. 1966).

15. 256 F. Supp. 195 (M.D. Ala. 1966), *vacated and remanded*, 387 U.S. 97 (1967).

16. 256 F. Supp. 824 (M.D. Tenn. 1966), *noted in* 20 VAND. L. REV. 649 (1967).

17. Judge Miller added that it was fruitless to pursue the elusive distinction between administrative and legislative functions. Strickland v. Burns, 256 F. Supp. 824, 836 (M.D. Tenn. 1966) (concurring opinion).

elective process. However, in a 1966 decision[18] the Court emphasized that its reapportionment cases hold only that when a state provides for an election of a state official all voters must be treated as equally as possible.[19]

The Court in the instant case determined that the Michigan system for selecting county school board members was "basically appointive rather than elective," and that while the board's functions were important, they were essentially administrative rather than legislative in the classical sense. Noting that since political subdivisions of a state have traditionally been regarded as subordinate instrumentalities for performing state governmental functions, the Court observed that state governments possess vast discretion in administering these nonsovereign subdivisions. The Court further reasoned that a state may experiment with flexible and unique municipal arrangements to enable local governments to meet the challenge of changing urban conditions, so long as it does not defeat any federally protected right in the process. The Court concluded that since an election was neither required, nor directly involved in the selection of a local board essentially administrative in character, the principle of "one man, one vote" was inapplicable.

By the disposition of the instant case the Court provided several sources of confusion and possible litigation. First, in view of its diverse powers it is questionable whether the Kent County School Board would traditionally be regarded as an administrative body. Consequently, the use of the administrative-legislative distinction appears arbitrary, for even if the distinction is a valid one, the Court provides no guidelines for future determinations involving similar bodies. The arbitrary nature of this distinction is exemplified in the decision in *Kramer v. Union Free School District No. 15*[20] where the Second Circuit interpreted the instant case as holding that all school boards are administrative bodies, effectively excluding the "one man, one vote" principle from the selection of local school boards.[21] The administrative-legislative distinction becomes unimportant when consideration is given to the duties performed by such governmental bodies, and the inextricable ties between these duties and the welfare of all

18. Forston v. Morris, 385 U.S. 231 (1966), where Georgia's provision for selecting a Governor by vote of the state legislature when no candidate receives a majority of the popular vote was held not invalid under the equal protection clause.

19. In Delozier v. Tyrone Area School Bd., 247 F. Supp. 30 (W.D. Pa. 1965), the court admitted that the legislature could administer its school system without elective boards, but since an elective method was utilized it must comply with fourteenth amendment standards.

20. 379 F.2d 491 (1967).

21. The school board is the most common form of local governing body in the United States, numbering over 34,000. Note, *Reapportionment*, 79 Harv. L. Rev. 1226, 1275 nn. 28 & 29 (1966).

the community. It is submitted that it would be preferable to give decisive weight not to the form of selection, but rather to the substantive importance of the powers and functions possessed by a local governing unit, balancing these factors against the value of the state's interest in preserving the system as established. The burden would then be on the state to justify the absence of equal protection as guaranteed by the fourteenth amendment under the present system. Applying this test to the situation in the instant case, it is submitted that the importance of the duties and the potential effect on the citizenry far outweigh any utility in preserving the present procedure.

Labor Law—Union Empowered To Expel Member for Failure To Exhaust Union Appellate Remedies

Defendant labor union expelled a member for bringing charges before the National Labor Relations Board without first exhausting his intra-union remedies as required by the union's constitution.[1] The member then brought a second action before the Board, alleging that his expulsion violated section 8(b)(1)(A) of the National Labor Relations Act (NLRA).[2] The union contended that its action was a lawful exercise of its right to administer its own internal affairs under section 8(b)(1)(A) of the NLRA and section 101(a)(4) of the Labor-Management Reporting and Disclosure Act (LMRDA).[3] The

1. The union member, Edwin Holder, filed intra-union charges with his local alleging that the union had caused his employer to discriminate against him because of "certain legally protected activity," the substance of which was not set out in the record. After the local union dismissed the charges, Holder, ignoring his union's constitution which provided for an appeal from decision of the trial board of the local to the General Executive Board of the international body and which required that members exhaust all remedies within the union before bringing an action in a court or agency, brought an unfair labor practice proceeding before the National Labor Relations Board, alleging the same offense. After the Board dismissed this action, Holder's local union trial board convicted him of violating the above cited provision of the union constitution and expelled him from the union.

2. National Labor Relations Act § 8(b)(1)(A), 29 U.S.C. § 158(b)(1)(A) (1964), which provides:

"It shall be an unfair labor practice for a labor organization or its agents (1) to restrain or coerce (A) employees in the exercise of the rights guaranteed in section [7] of the title: *Provided*, That this paragraph shall not impair the right of a labor organization to prescribe its own rules with respect to the acquisition or retention of membership therein . . . ."

Section 7 of the Act, 29 U.S.C. § 157 (1964), confers on employees "the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities . . . ."

3. Labor-Management Reporting & Disclosure Act of 1959, § 101(a)(4), 29 U.S.C.

Board found the union guilty of an unfair labor practice and issued an order requiring the member's reinstatement.[4] On appeal to the Court of Appeals for the Third Circuit, *held,* reversed. A union's expulsion of a member for failing to exhaust his intra-union remedies before filing an unfair labor practice charge with the National Labor Relations Board is not an unfair labor practice under section 8(b)(1)(A) of the NLRA. *Local 22, Marine & Shipbuilding Workers v. NLRB,* 379 F.2d 702 (3rd Cir. 1967).

Section 101(a)(4) of the LMRDA prohibits unions from impeding any member's access to a court or administrative agency, but allows unions to require members "to exhaust reasonable hearing procedures . . . before instituting legal or administrative proceedings . . . ."[5] Unions have contended that the proviso to this section confers on them power to punish members who violate union rules requiring the exhaustion of intra-union appellate procedures. One line of court decisions has accepted this reasoning,[6] emphasizing the statute's recognition of the need to preserve a union's control over its own affairs.[7] A second group of decisions, however, places greater emphasis on the legislative intent underlying the initial sentence of section 101(a)(4)—to protect an employee's right to bring charges against either an employer or a union before an agency or court. These decisions hold that the proviso to the section merely confers discretionary power on the agency or court, rather than on the union, to dismiss the action until the member has exhausted reasonable intra-union remedies.[8] Apart from section 101(a)(4) of the LMRDA, section 8(b)(1)(A) of the NLRA, while prohibiting labor unions from coercing members "in the exercise of rights guaranteed in section 7," allows a union to "prescribe its own rules with respect to the acquisition or retention of membership therein . . . ."[9] In 1964, the

§ 411(a)(4) (1964): "No labor organization shall limit the right of any member thereof to institute an action in any court, or in a proceeding before any administrative agency . . . *Provided,* That any such member may be required to exhaust reasonable hearing procedures (but not to exceed a four-month lapse of time) within such organization, before instituting legal or administrative proceedings against such organization . . . ."

4. Local 22, Marine & Shipbuilding Workers, 159 N.L.R.B. 95 (1966).

5. *See* note 3 *supra* for relevant provisions.

6. Sheridan v. Local 626, Carpenters, 306 F.2d 152 (3rd Cir. 1962); Detroy v. American Guild of Variety Artists, 189 F. Supp. 573 (S.D.N.Y. 1960), *rev'd,* 286 F.2d 75 (2d Cir. 1961), *cert. denied,* 366 U.S. 929 (1961); *cf.* Thompson v. New York Cent. R.R., 250 F. Supp. 175 (S.D.N.Y.), *aff'd,* 361 F.2d 137 (2d Cir. 1966).

7. *Cf.* Local 283, UAW, 145 N.L.R.B. 1097, 1100 (1964); "[I]t is nonetheless evident that internal union disciplines were not among the restraints intended to be encompassed by [§ 8(b)(1)(A)]."

8. Detroy v. American Guild of Variety Artists, 286 F.2d 75 (2d Cir.), *cert. denied,* 366 U.S. 929 (1961); *see, e.g.,* Ryan v. Local 134, Elec. Workers, 361 F.2d 942 (7th Cir.), *cert. denied,* 385 U.S. 935 (1966); Deluhery v. Marine Cooks & Stewards Uniou, 211 F. Supp. 529 (S.D. Cal. 1962).

9. *See* note 2 *supra* for relevant provisions.

National Labor Relations Board faced for the first time the question of whether a union could *affirmatively* enforce its power under the proviso to section 8(b)(1)(A) by fining or expelling members for failing to exhaust intra-union procedures before bringing an action against the union before a court or agency.[10] In *Local 138, Operating Engineers,*[11] a member, whom the union had expelled solely for failing to exhaust his intra-union remedies, brought an unfair labor practice action, claiming that section 8(b)(1)(A) prohibited his expulsion. In ordering the member's reinstatement, the Board stated that for reasons of public policy a union member's right to bring charges against the union before the Board was guaranteed by section 7 of the NLRA and thus protected by section 8(b)(1)(A). The Board declared that since an employer was expressly prohibited from discriminating against employees because they brought charges,[12] a union was prohibited by implication from punishing its members for the same reason.[13]

The court in the instant case expressly overruled *Local 138, Operating Engineers.* The court found no basis for implying from section 8(b)(1)(A) an unqualified right under section 7 to bring charges before the Board. It noted that section 7 deals only with rights incident to organization and bargaining and is silent as to the right of union members to file charges. The court stated that if a member's complaint concerns section 7 rights, he should be permitted to proceed before the Board without fear of expulsion.[14] The court rejected the argument that unions are impliedly included in the provision which prohibits employers from discriminating against

10. Before 1964, unions, proceeding under the proviso to section 101(a)(4), rather than section 8(b)(1)(A) of the NLRA, had sought to use a member's failure to exhaust union procedures only as a defense to the member's suit, not as an affirmative basis for penalizing the member.

11. 148 N.L.R.B. 679 (1964).

12. *See* National Labor Relations Act § 8(a)(4), 29 U.S.C. § 158(a)(4) (1964).

13. *Local 138, Operating Eng'rs* was cited with approval in Roberts v. NLRB, 350 F.2d 427 (D.C. Cir. 1965). The court assumed "that 'the right of an employee to file charges is protected under Section 7.'" *Id.* at 428. Recognizing that the proviso to section 101(a)(4) conferred power on the agency rather than on the union, the court said: "The proviso does authorize, indeed it may require, the agency or court to which the member comes for relief to withhold the exercise of its authority—for four months if reasonable internal procedures are available. . . . Approval of such restraint by agency or court is quite different, however, from freeing the Union itself to impose a fine for failure of a member to exhaust such procedures." *Id.* at 430.

14. The court noted that "a section 8(b)(1)(A) unfair labor practice can be established here by showing that rights incident to organization or bargaining were the basis of Holder's complaint which led to union action, and in no other way." Local 22, Marine & Shipbuilding Workers v. NLRB, 379 F.2d 702, 706 (3rd Cir. 1967). Since the record failed to reveal the basis for the original complaint, the court was unable to affirm. The court noted that had this been the only error, it would have remanded the case for consideration of whether section 7 rights were involved.

a union member for bringing an action before the Board.[15] Noting that a section explicitly proscribing such union discrimination was deleted from the NLRA before it was enacted,[16] the court felt that it should not replace this prohibition by construction.[17] Furthermore, the court stated that the proviso to section 8(b)(1)(A), which allows unions to prescribe rules in regard to the acquisition or retention of membership, protected the union's action. The court declared that this rule neither offends public policy nor impedes the normal administration of the Act, because it merely requires a member to give his union a "fair opportunity to correct its own wrong;"[18] in fact, by relieving the Board of grievances which could be settled within the union, such a policy enhances the administration of the Act. Nor, stated the court, does such a rule detrimentally affect a member's right to appear before the Board; it only requires him to exhaust reasonable union remedies first.[19] Finally, the court noted that section 101(a)(4) of the LMRDA is consistent with the decision, because the proviso to this section expressly confers on a union the power to require a member to exhaust his intra-union procedures before proceeding before the Board.[20]

The court's decision to prefer the policy of allowing the union to police its own internal activities over the policy against restricting a member's access to the Board is justified both by statutory language and by legislative history. Section 7 of the NLRA does not purport to give a union member an unqualified right to sue his union, while section 101(a)(4) of the LMRDA appears to give unions power to require a member to exhaust his union procedures first, thus impliedly empowering it to penalize a member's failure to do so. Furthermore, public policy also seems to support this decision. While not unduly limiting a member's access to the Board, this decision encourages

15. *See* National Labor Relations Act § 8(a)(4), 29 U.S.C. § 158(a)(4) (1964).

16. *See* 1 Leg. Hist. L.M.R.A. 53-54 (1948); H.R. Conf. Rep. No. 510, 80th Cong., 1st Sess. 46 (1947), in U.S. Code Cong. Service 1135, 1151 (1947).

17. *Cf.* Local 1976, Carpenters v. NLRB, 357 U.S. 93, 99-100 (1958).

18. Local 22, Marine & Shipbuilding Workers v. NLRB, 379 F.2d 702, 707 (3rd Cir. 1967).

19. In dictum, the court conceded an agency's power to evaluate the reasonableness of the union's procedures: "Of course, a court or an administrative agency will determine for itself whether the alleged intra-union remedy is in fact available and whether resort to it would impose unreasonable delay or hardship upon the complainant." *Id.* at 707.

20. "Logically, and in normal reading, the attendant and qualifying proviso is an exception stating what such an organization may do despite the preceding general restriction npon its action. Moreover, there is no need for a proviso to authorize a court or an administrative body to postpone its action until a litigant shall exhaust intra-union remedies, since judicial and quasi-judicial bodies frequently exercise such discretionary power to postpone their own action pending the exhaustion of other remedies as a matter of inherent right without benefit of legislation." Local 22, Marine & Shipbuilding Workers v. NLRB, 379 F.2d 702, 708 (3d Cir. 1967).

democratic practices within the union and reduces the workload of the Board by promoting settlement of disputes without litigation.[21] But it should be noted that there are dangers implicit within the instant decision. There is no satisfactory framework for determining the reasonableness of the union appellate procedures. Consequently, the member must risk possible expulsion to challenge the reasonableness of the union's remedies before the Board. This would seem to permit the union the opportunity to impose on members unreasonable remedies, which because of the great risk involved will go unchallenged.[22] This problem could be solved by allowing a union member to appear before a court or an agency solely to test the reasonableness of the union's procedures without being subject to punishment by the union. Hopefully, such a rule will be either developed in subsequent cases or enacted by legislative amendment.

Taxation–Federal Estate Taxation–State Trial Court Judgments on Property Rights Not Conclusive on Federal Courts Adjudicating Federal Tax Consequences

The Commissioner of Internal Revenue denied taxpayer's estate tax marital deduction on the ground that decedent's widow had executed a release instrument converting her general testamentary power of appointment into a special power of appointment[1] which does not qualify under section 2056(b)(5) of the Internal Revenue Code.[2] The executor filed a petition for redetermination in the Tax Court of the United States and, while this case was pending,[3] brought an action in the New York Supreme Court[4] for a determination of the

21. *See generally*, Comment, *Union Settlement of Disputes, the Rights of Members, and the Role of the Doctrine of Exhaustion of Remedies*, 9 WAYNE L. REV. 361 (1963).

22. *See* Ryan v. Local 134, Elec. Workers, 361 F.2d 942 (7th Cir.), *cert. denied*, 385 U.S. 935 (1966).

1. Grantor created an amendable and revocable trust in 1930, the income from which was to be paid to his wife for her life. An amendment executed in 1931 gave the grantor's wife a general power to appoint the remainder by will, and provided for other disposition in case of default by the grantee. Grantor's wife executed the release in 1951 to take advantage of the Powers of Appointment Act of 1951, INT. REV. CODE of 1939, § 811(f) (Now INT. REV. CODE of 1954, § 2041), and to prevent the taxation of the trust assets as part of her estate. Commissioner v. Estate of Bosch, 363 F.2d 1009, 1010 (2d Cir. 1966).

2. INT. REV. CODE of 1954, § 2056(b)(5). Together with § 2056(a), this section allows a deduction from the gross estate for the value of an interest in property passing from the decedent to his surviving spouse, if the spouse is entitled to all the income for life, and alone has a power to appoint the interest in favor of herself, her estate or both.

3. The Tax Court, with petitioner's consent, abstained from making its decision pending the outcome of the state court action.

4. The petitioner was not made a party to the state action..

validity of the release instrument. All the parties represented argued for the invalidity of the release instrument,[5] and the New York court held that the release was a nullity.[6] The Tax Court then allowed the deduction, stating that the New York Supreme Court's decision was "an authoritative exposition of New York law. . . ."[7] The Court of Appeals for the Second Circuit affirmed the Tax Court's decision.[8] On certiorari to the United States Supreme Court, *held*, reversed. Where federal estate tax liability turns on property rights determined by state law, the determination of such rights by a state trial court is not binding on federal authorities when the United States is not a party to the proceeding. *Commissioner v. Estate of Bosch,* 387 U.S. 456 (1967).[9]

Although Congress determines what property rights or interests are to be taxed, state law is controlling in determining the nature of these rights and interests.[10] Even before state-determined property rights were made the subject of federal taxation as it exists today, it was settled law that the decisions of the highest court of a state interpreting the state property laws were binding on the federal courts.[11] The United States Supreme Court in *Freuler v. Helvering*[12] later determined that decisions by state courts of competent jurisdiction construing state property laws were binding on federal courts for the federal tax consequences based on those rights, in the absence of fraud or collusion.[13] But the Court was careful to point out that such state adjudications, if rendered in the absence of federal representa-

5. Three briefs were filed on behalf of the widow, the trustee, and an infant beneficiary by the guardian ad litem. No argument for the validity of the release was presented. Commissioner v. Estate of Bosch, 363 F.2d 1009, 1011 (2d Cir. 1966).

6. Matter of Irving Trust Co. (N.Y. Sup. Ct., Special Term, Nov. 15, 1963), *cited in* 363 F.2d at 1011 n.3.

7. Estate of Bosch, 43 T.C. 120, 124 (1964).

8. Commissioner v. Estate of Bosch, 363 F.2d 1009 (2d Cir. 1966) (Friendly, J., dissenting).

9. A companion case, Second Nat'l Bank v. United States, 351 F.2d 489 (1965), also involving a marital deduction under § 2056(b)(5), was decided in the *Bosch* opinion. Another panel of the Second Circuit stated in dictum in that case that under no circumstances could decrees of the Connecticut Probate Court be construed as binding on a federal court in a subsequent tax proceeding. The court based this on the facts that Connecticut Probate Court decrees are not binding on the state's higher courts and are even subject to collateral attack in another probate district in the state. The court found it unnecessary to determine whether the probate court proceeding was collusive. On certiorari to the United States Supreme Court, *held*, affirmed. 387 U.S. 456 (1967).

10. Helvering v. Stuart, 317 U.S. 154, 161-62 (1942); Morgan v. Commissioner, 309 U.S. 78, 80 (1940).

11. Blair v. Commissioner, 300 U.S. 5, 9-10 (1937); Spindle v. Shreve, 111 U.S. 542, 546 (1884); Nichols v. Levy, 72 U.S. (5 Wall.) 433, 444 (1866).

12. 291 U.S. 35, 44-45 (1934) (California decree on trustee's account was binding for federal income tax purposes).

13. *Id; see* Blair v. Commissioner, 300 U.S. 5, 10 (1937) (for federal income tax purposes, validity of assignments by petitioner, life beneficiary of Illinois trust, had previously been determined by state appellate court).

tion, were not res judicata.[14] The failure of the Court to develop a definitive standard to determine conclusiveness[15] has subsequently engendered diverse determinations in the federal circuit courts.[16] The *Gallagher* rule, formulated by the Third Circuit,[17] provides that a lower state court judgment is controlling in federal courts if it is a final and binding adjudication of the parties' rights, even though the judgment is the product of a non-adversary proceeding or is a consent decree.[18] The rule is justified on the ground that the taxpayers' rights to income or other property sought to be taxed are determined, so far as the enjoyment of the property is concerned, in state courts whose decisions are final and binding, and a different decision in a federal court would not change these rights. The Fourth, Fifth, Sixth, Seventh, and Tenth Circuits have adopted the opposite position that a lower state court judgment is not conclusive on federal courts unless it is the product of an adversary hearing on the merits.[19] In reaching this position the respective circuits have used various criteria to determine whether a state court decree is the result of a bona fide adversary proceeding, for example, notice to interested parties,[20] oral argument

14. *See* Blair v. Commissioner, 300 U.S. 5 (1937).

15. "Conclusive" refers to the finality accorded a state court determination of the rights of the parties before it, when such rights are at issue in a federal tax proceeding.

16. A source of confusion in this area is the Court's use of the term "collusion" without defining it. In Freuler v. Helvering, 291 U.S. 35, 45 (1934), the Court refused to hold, at the urging of the federal government, that the proceeding in state court was collusive "in the sense that all the parties joined in a submission of the issues and sought a decision which would adversely affect the Government's right to additional income tax." However, the Court failed to give a clear definition of collusion. The Court has never decided a case in which it found "collusion" as alleged by the Government in *Freuler*. Braverman & Gerson, *The Conclusiveness of State Court Decrees in Federal Tax Litigation*, 17 TAX L. REV. 545, 551 (1962).

17. Enunciated in Gallagher v. Smith, 223 F.2d 218 (3d Cir. 1955) (consent decree rendered by Pennsylvania orphan's court was binding on Commissioner).

18. "[W]hether the proceeding was adversary or nonadversary is not the test of conclusiveness . . . but rather whether the judgment is an adjudication by the state court of a property right upon which solely the federal tax is imposed, which adjudication was and is final and binding upon the parties under state law, and which was not obtained by collusion for the purpose of defeating the tax." Gallagher v. Smith, 223 F.2d 218, 226 (3d Cir. 1955). It should be noted that the Supreme Court has never specifically ruled as to whether consent decrees are binding on federal courts in tax cases.

19. These circuits have adopted the definition of collusion alleged by the Government in Freuler v. Helvering, 291 U.S. 35 (1934), set out in note 16 *supra*, and have applied it strictly as a test of collusion. Leading cases in the respective circuits are as follows: Old Kent Bank & Trust Co. v. United States, 362 F.2d 444 (6th Cir. 1966) (replacing, but not explicitly overruling, Goodwin's Estate v. United States, 201 F.2d 576 (6th Cir. 1953), which advocated a position near that of the *Gallagher* rule of the Third Circuit); Pierpont v. Commissioner, 336 F.2d 277 (4th Cir. 1964), *cert. denied*, 380 U.S. 908 (1965); Faulkerson's Estate v. United States, 301 F.2d 231 (7th Cir. 1962), *cert. denied*, 371 U.S. 887 (1962); *In re* Sweet's Estate, 234 F.2d 401 (10th Cir. 1956), *cert. denied*, 352 U.S. 878 (1956); Saulsbury v. United States, 199 F.2d 578 (5th Cir. 1952), *cert. denied*, 345 U.S. 906 (1953).

20. Faulkerson's Estate v. United States, 301 F.2d 231 (7th Cir. 1962), *cert. denied*, 371 U.S. 887 (1962).

and representation by counsel,[21] jurisdiction of the state court,[22] and appeal.[23] The rationale adopted by these circuits is that state court decisions should not be binding upon the federal government since it did not have representation or a right of appeal, especially if such proceedings were initiated solely to procure decisions adversely affecting the Government's right to additional tax.[24] Variations of these two positions have been adopted in the remaining circuits.[25]

In the instant case the Court stated that the state court proceedings were obviously brought to preclude federal tax liability and that the judgments could not be res judicata since the Commissioner had not been made a party.[26] The Court found that the report of the Senate Finance Committee, which had recommended the enactment of the marital deduction, stated that "proper regard,"[27] not finality, should be given to a state court interpretation and then only when entered by a

21. Pierpont v. Commissioner, 336 F.2d 277 (4th Cir. 1964), *cert. denied,* 380 U.S. 908 (1965).

22. Faulkerson's Estate v. United States, 301 F.2d 231 (7th Cir. 1962), *cert. denied,* 371 U.S. 887 (1962).

23. Apparently taking their cue from Blair v. Commissioner, 300 U.S. 5, 10 (1937)—where the Court, in stating that the decision of the state court was conclusive, said that "[i]t matters not that the decision was by an intermediate appellate court"—the following circuits have determined this: Pierpont v. Commissioner, 336 F.2d 277 (4th Cir. 1964), *cert. denied,* 380 U.S. 908 (1965); Faulkerson's Estate v. Commissioner, 301 F.2d 231 (7th Cir. 1962), *cert. denied,* 371 U.S. 887 (1962); Kelly's Trust v. Commissioner, 168 F.2d 198 (2d Cir. 1948). The First Circuit in Channing v. Hassett, 200 F.2d 514 (1st Cir. 1952), implies that it would hold this. For criticism of this position, see Colowick, *The Binding Effect of a State Court's Decision in a Subsequent Federal Income Tax Case,* 12 TAX L. REV. 213, 226 (1957).

24. *See* cases cited note 19 *supra.*

25. A variation of the Third Circuit position is found in the First Circuit where the court refused to hold as conclusive an uncontested and unappealed probate court decision arrived at subsequent to a federal district court ruling on the same matter with which it conflicted, but it determined that it could not disregard it entirely in its own determination of the Massachusetts law. Channing v. Hassett, 200 F.2d 514 (1st Cir. 1952). *See* Third National Bank & Trust Co. v. United States, 228 F.2d 772 (1st Cir. 1956). Variations of the second position are found in the Eighth and Ninth Circuits as follows: The Eighth Circuit does not automatically presume collusion if the state proceeding yielded a consent judgment, but prefers to scrutinize all the circumstances of the state court proceeding before rejecting it as binding. Peyton's Estate v. Commissioner, 323 F.2d 438 (8th Cir. 1963). The Ninth Circuit has compiled a list of indices to determine whether or not a state court judgment is to be deemed conclusive, among which are the nature of the right determined, whether federal authorities had notice of the proceeding and whether its judgment appears correct. Consent decrees are not presumed to be collusive, and the burden is on the Commissioner to produce any evidence of collusion if it is alleged. Flitcroft v. Commissioner, 328 F.2d 449 (9th Cir. 1964). The Second Circuit gave indications that it might be grouped with this second position in Kelly's Trust v. Commissioner, 168 F.2d 198 (2d Cir. 1948). But the court stated in Commissioner v. Bosch, 363 F.2d 1009, 1016 (2d Cir. 1966) that whether decisions of state trial courts are binding on federal courts in subsequent tax litigation was an open question in the circuit.

26. The Commissioner was not made a party in either of the suits included in the instant opinion.

27. S. REP. No. 1013, Pt. 2, 80th Cong., 2d Sess. 4 (1948).

court "in a bona fide adversary proceeding." The detailed statutory limitations placed on the allowance of the marital deduction indicated to the Court that Congress intended that these provisions be strictly construed since their purpose is to eliminate tax loopholes. From this specificity of language used both in the statute and in the committee report the Court determined that if Congress had intended state trial court judgments to be conclusive on federal courts in tax litigation it would have so stated. The Court also noted that the Rules of Decision Act,[28] has been construed as a declaration that decisions of the highest court of a state interpreting state law are conclusive on federal courts,[29] but that the decisions of lower state courts, while meriting some weight, are not controlling.[30] The Court reasoned that these principles apply to federal tax litigation for the same reasons that they apply to diversity cases—that "the underlying substantive rule involved is based on state law and the State's highest court is the best authority for its own law."[31] Reversing the court of appeals, the Court held that decisions of the highest courts of the states construing state law are binding on the federal courts, and that decisions by intermediate appellate state courts are evidence of state law which are not to be disregarded by federal courts unless they are convinced that that state's highest court would rule differently. In the absence of decisions by the state's highest court, the Court held that the federal courts are to make their own determinations of state law, giving "proper regard" only to relevant judgments entered by state trial courts in "bona fide adversary proceedings."

In a dissenting opinion,[32] Mr. Justice Harlan, rejecting the majority's

28. U.S.C. § 1652 (1964), which provides that in the absence of federal requirements such as the Constitution or acts of Congress, the "laws of the several states . . . shall be regarded as rules of decision in civil actions in the courts of the United States, in cases where they apply."

29. Erie R. R. v. Tompkins, 304 U.S. 64 (1938). *Erie*, a case based on diversity jurisdiction, determined that judicial decisions of a state's highest court are to be regarded as "the laws of . . . the states" within the meaning of the Rules of Deeision Act, 28 U.S.C. § 1652 (1964). *Erie* was silent on the effect to be given deeisions by lower state courts on questions never determined by the highest state court, because the issue before the court had been decided by a state's highest court. However, the reasoning of the decision, *i.e.*, that "no clause in the Constitution purports to confer such a power upon the federal courts," was directed not to the level of state court but rather to the power which is reserved to the states by the Constitution, 304 U.S. at 78-80.

30. King v. Order of United Commercial Travelers of America, 333 U.S. 153 (1948).

31. 387 U.S. at 465.

32. 387 U.S. at 471. Two other dissenting opinions were written: Mr. Justice Douglas advocated a continued adherence to Freuler v. Helvering, 291 U.S. 35 (1934), and Blair v. Commissioner, 300 U.S. 5 (1937), holding lower state court judgments conclusive on federal courts for their tax consequences in the absence of fraud or collusion. He dissents from the majority's view of Erie R. R. v. Tompkins, 304 U.S. 64 (1938), and cases following, on the weight to be accorded lower state court decisions in diversity cases brought in federal courts. He states that in the diversity cases the Court has held "that the federal court is obligated to follow the decision of a lower

single standard as too rigid an approach, stated that the character of both the state proceeding and the state court were relevant considerations in determining a decision's conclusiveness. Contrasting the state interest of having its own courts determine state law so as to insure its uniformity with the federal interest of protecting the sources of federal revenue, he advocated a compromise. Since federal interests are satisfied if a considered judgment of the applicable state law is obtained, decisions rendered in genuine adversary proceedings should be presumed conclusive. To accommodate federal interests, the taxpayer challenging the Commissioner's ruling should have the threshhold burden of showing that the state proceeding was a reasoned resolution of competing interests, as indicated by such factors as actual adversity of financial and other interests, presentation of reasoned argument, and appeal.

The instant case provides a standard which imposes a uniform rule upon the previously divided circuits, and silences the controversy over collusion and adversary adjudication. Although this substitution of the one standard for the several would seem to be an improvement, the rigidity of the new standard may introduce several new problems. The new standard renders state trial court judgments subject to review regardless of their nature. As a result, sound adversary adjudications by state trial courts are distinguished from collusive or fraudulent state court proceedings only by the "proper regard" they are to be accorded in federal court. While the likelihood of collusive, nonadversary state proceedings determining federal tax liabilities is thereby reduced, this is accomplished at the expense of downgrading sound adversary adjudications and of increasing the frequency of federal determination of state law. The burden on a taxpayer who has had his rights determined in a proper, adversary state proceeding is increased, for he must now relitigate these issues on the federal level instead of merely demonstrating the adversary nature of the state proceeding. Furthermore, the possibility of conflicting interpretations of his property rights on the state and federal levels is increased, if not encouraged, ultimately impairing the uniformity of law within each state. The effect of these inconsistent interpretations will burden not only the individual taxpayer but also the state's administration of its laws. The relationship between the state and federal judiciaries is too complex to be controlled by a single, rigid

state court in the absence of decisions of the State Supreme Court showing that the state law is other than announced by the lower court." 387 U.S. at 466. Mr. Justice Fortas joined Mr. Justice Harlan in his dissent, and wrote a separate opinion in which he listed six factors, taken from Judge Raum's opinion in Estate of Bosch, 43 T.C. 120, 123-24 (1964), which would aid federal courts in determining whether a lower state court decision is to be accepted as conclusive on federal courts for its tax consequences.

standard.[33] A better approach may be that recommended by Mr. Justice Harlan which recognizes the interests of both sides by taking a flexible approach which stresses adversary adjudication of the taxpayer's property rights rather than federal adjudication of those rights. This approach, complemented by guidelines[34] which would aid the federal courts in recognizing sound adversary adjudications in state courts, would have provided for a more equitable resolution of tax liabilities and would have better served the federal system of government than the approach taken by the majority.

Taxation—Federal Income Tax—Effect of Close Corporation Voting Trust on Right to Subchapter S Election

Plaintiff corporation elected to be treated as a "small business corporation" pursuant to subchapter S of the Internal Revenue Code.[1] Subsequent to this election, the corporation's four shareholders, in order to achieve stability of management policy, entered into a voting trust agreement[2] giving one of the stockholders the irrevocable right to vote all stock for ten years. The shareholders listed corporate losses as deductions on their personal income tax returns.[3] The Commissioner disallowed these deductions on the ground that the creation of the voting trust prevented the plaintiff corporation from qualifying under subchapter S. The Commissioner asserted first, that the voting trust created a separate class of stock in violation of section 1371 (a)(4),[4]

33. Hill, *The Erie Doctrine in Bankruptcy*, 66 Harv. L. Rev. 1013 (1953); Note, *The Competence of Federal Courts to Formulate Rules of Decision*, 77 Harv. L. Rev. 1084 (1964).

34. Such as are listed in Mr. Justice Fortas' dissenting opinion, 387 U.S. at 483-84.

1. Int. Rev. Code of 1954, §§ 1371.77.

2. As provided by Ohio Rev. Code § 1701.49 (1963).

3. Int. Rev. Code of 1954, § 1374(b). This section provides that, "each person who is a shareholder of an electing small business corporation at any time during a taxable year of the corporation in which it has a net operating loss shall be allowed as a deduction from gross income, for his taxable year in which or with which the taxable year of the corporation ends . . . an amount equal to his portion of the corporation's net operating loss." A shareholder's pro rata share of the corporation's net operating loss is defined by § 1374(c) as the sum of the portions of the corporation's daily net operating loss attributable on a pro rata basis to the shares held by him on each day of the taxable year.

4. "For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which . . . does not . . . have more than one class of stock." The government's theory was that while the voting trust did not technically create two classes of stock, the practical result was the same as if it had done so. By vesting the power to vote in one shareholder, the other shareholders were stripped

and secondly, that the voting trust was a shareholder other than an individual in violation of section 1371(a)(2).[5] On trial, the federal district court *held,* plaintiff's motion for summary judgment granted. The shareholders of a small business corporation do not forfeit a subchapter S election by the creation of a voting trust. *A. & N. Furniture & Appliance Co. v. United States,* 271 F. Supp. 40 (S.D. Ohio 1967).

In 1958, Congress enacted subchapter S of the Internal Revenue Code "to make it possible for small corporations which are essentially partnerships to enjoy the advantages of the corporate form of organization without being made subject to possible tax disadvantages of a corporation."[6] The purpose of the provision was to eliminate the influence of the federal income tax in the selection of the form of business organization which may be most desirable under the circumstances.[7] Subchapter S provides an election for small business corporations which is designed to eliminate the tax at the corporate level and hence result in a single tax on the shareholder at his individual rate, just as if he were a partner or proprietor engaged in a similar business.[8] Among other tax features, shareholders are entitled to deduct from their personal income tax their proportionate share of the

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of that power. The government contended that this had the effect of giving one shareholder voting stock, while the other shareholders held non-voting stock. Thus, the voting trust, in effect, created a two-class stock structure while retaining the form of a single class stock structure. The Government relied on Treas. Reg. § 1.1371-1(g) (1959) and Rev. Rul. 63-226, 1963-2 CUM. BULL. 341, to support its position.

5. "For purposes of this subchapter, the term 'small business corporation' means a domestic corporation which . . . does not . . . have as a shareholder a person (other than an estate) who is not an individual." The Government relied on Treas. Reg. § 1.1371-1(e) (1959) to support its contention on this point. That Regulation states: "A corporation in which any shareholder is a corporation, trust, or partnership does not qualify as a small business corporation. The word 'trust' as used in this paragraph *includes . . . voting trusts.* Thus . . . *the corporation in which such a trust is a shareholder does not meet the qualifications of a small business corporation*" for purposes of a subchapter S election. (Emphasis added).

6. *See* S. REP. No. 1983, 85th Cong., 2d Sess. 87 (1958). Subchapter S was designed to make investment in corporate business more attractive by eliminating certain onerous tax consequences of earlier Code provisions. George B. Lourie points out that "[i]n recent years . . . the incentive of an individual to invest in a corporate business has been severely blunted by the fact that if the business did not prove successful, he was permitted only a capital loss in most situations. If the business proved successful, the individual taxpayer investing in a corporate business would be subject to full and, usually, double taxation. . . . Subchapter S . . . permits the individual stockholder to take . . . [an ordinary] loss in the same year that it is incurred by the corporate business. To this extent it gives a far greater incentive to the individual taxpayer to make his corporate investment." Lourie, *Subchapter S After Six Years of Operation: An Analysis of Its Advantages and Defects,* 22 J. TAX. 166, 167 (1965).

7. A provision similar to subchapter S was proposed in 1954 with the same purpose in mind. Though not passed then, it was revived in 1958 and passed as subchapter S. *See* S. REP. No. 1622, 83d Cong., 2d Sess. 118 (1954).

8. *Id.*

corporation's net operating loss.[9] Subchapter S is applicable only to "small business corporations," defined in section 1371(a) as domestic corporations having only one class of stock, with no more than ten shareholders, all of whom must be United States citizens and either individuals or the estates of former shareholders. The purpose of the requirement that an electing corporation have only one class of stock was to make possible a simple and uncomplicated allocation of income and loss among shareholders. There was a desire to avoid the complex tax accounting problems involved in passing corporate earnings through to shareholders where the shares held were of different types and had different rights attaching to them.[10] The Treasury Regulations provide that an agreement between stockholders which restricted the voting rights of any stockholder, *e.g.*, a voting trust,[11] created in effect a second class of stock in the hands of the restricted stockholder, rendering a subchapter S election unavailable.[12] This position has been questioned by various writers and attacked in dictum by at least one court.[13] As to the requirement that the shareholders be either shareholders or decedent's estates, the Regulations expressly provide that the ownership of stock by a corporation, partnership, or trust disqualifies the corporation for election.[14] However, there was apparently

9. *See* note 6 *supra*. For an excellent discussion of these features of subchapter S, see generally, Strecker, *When Will the Corporate Form Save Taxes?*, 18 VAND. L. REV. 1695 (1965). *See also* Note, *Subchapter S of the 1954 Code*, 33 ST. JOHNS L. REV. 187 (1958); Note, *Stockholder Agreements and Subchapter S Corporations*, 19 TAX L. REV. 391 (1964).

10. Schwartz, *New Subchapter S Law Passed: Relaxed Rules Require Re-examination of Election*, 24 J. TAX. 370, 374 (1966).

11. A voting trust has been defined as a "device by which shareholders transfer their shares to voting trustees under an agreement that the trustees shall have the right to vote the shares for the period and in the manner stated in the agreement, the other rights such as that to dividends to be retained by the transferors . . . ." N. LATTIN, CORPORATIONS 321 (1959). Treas. Reg. § 1.1371-1(e) (1959), expressed the position that for purposes of subchapter S, a voting trust is a "shareholder" and as such will disqualify the corporation utilizing it from election. The instant court is the first to test the validity of this regulation.

12. *See* Treas. Reg. § 1.1371-1(g) (1959); Rev. Rul. 63-226, 1963-2 CUM. BULL. 341.

13. Lourie, *supra* note 6, at 169: "This ruling is certainly of questionable validity and has been severely criticized by responsible tax practitioners." *See also* Note, *Stockholder Agreements and Subchapter S Corporations*, 19 TAX L. REV. 391 (1964). In Catalina Homes, Inc. v. Commissioner, 1964 P-H Tax Ct. Mem. ¶ 64,225, the court stated: "Because of our determination of the first issue herein, it will not be necessary for us to consider respondent's contentions that (1) the shares of stock in voting trusts constituted a second class of stock because of their loss of voting power, and (2) the voting trusts are to be considered shareholders of petitioner so as to disqualify it under § 1371(a)(4). *However, we do deem it appropriate to note our reservations as to whether these arguments represent a reasonable interpretation of the applicable statutory provisions and the intent of Congress in enacting subchapter S.*" (Emphasis added).

14. Treas. Reg. § 1.1371-1(e) (1959), quoted in note 5 *supra*. *See also* Catalina Homes, Inc. v. Commissioner, 1964 P-H Tax Ct. Mem. ¶ 64,225.

no prior case law on the question of whether a voting trust is a "shareholder" other than a natural person.

In the instant case, the court reasoned from the basic premise that the primary purpose of Congress in promulgating subchapter S was to permit small businesses to operate in any form desired without having to consider income tax consequences. The court declared that, in order to prevent interference with this basic purpose of subchapter S, the only legitimate concern of the Commissioner in this area should be in assuring that only "small corporations" made the election that the subchapter permitted,[15] and that only those corporations made the election whose stock structure would permit such action without resulting in excessively burdensome tax accounting complications for the government.[16] Applying these principles to the instant case, the court initially noted that the stock issued to the plaintiff corporation's shareholders was all voting common stock with each share having the same value to its respective owner as all other shares. Therefore, since each share commanded the same proportionate amount of distributions, and accounted for the same amount of losses as it did before the creation of the voting trust, the only real difference in stock structure after the trust was initiated lay in the voting power of the shareholders.[17] Deciding that a voting trust neither increased the size of the corporation, nor created tax accounting complications, the court dismissed the applicability of Treasury Regulation section 1.1371-1(g).[18] The court stated that the Regulation was only ap-

15. In order to qualify for subchapter S election a corporation cannot have more than ten shareholders and each shareholder must be an individual. INT. REV. CODE of 1954, § 1371(a)(4). Note that "small" refers only to the number of shareholders a corporation has, not to the amount of its assets. *See* note 5 *supra*. The court determined that Congress meant to limit subchapter S election to such small corporations because only small corporations were comparable to the partnership or proprietorship where earnings can be taxed to owners rather than to the business organization. As evidence of this intent, the court relied on Sen. Finance Comm., 83d Cong., 2d Sess., *Report on Internal Revenue Code of 1954*, in U.S. CODE CONG. & AD. NEWS 4752, 5096-98 (1954).

16. *Id.*

17. The court pointed out that the creation of the voting trust in the instant case only achieved one of the effects which would result from an actual two-class stock structure. That effect was the vesting of the voting power in the trustee-shareholder. The rights of the remaining shareholders to a proportionate distribution of dividends and/or earnings were unaffected. The shareholders were still entitled to the same proportionate benefits from the corporation as they were before the creation of the voting trust.

18. In pertinent part this regulation states: "A corporation having more than one class of stock does not qualify as a small business corporation. . . . If the outstanding shares of stock of the corporation are not identical with respect to the rights and interest which they convey in the control, profits, and assets of the corporation, then the corporation is considered to have more than one class of stock. Thus a difference as to *voting rights*, dividend rights, or liquidation preferences of outstanding stock will disqualify a corporation. . . ." (emphasis added). *See* note 4 *supra*.

propriate in instances where a corporation actually issues two classes of stock because accounting difficulties only arose where there were actual differences in the market value of the stock.[19] To accept the Government's position on this point, declared the court, would be to contravene the congressional intent to allow the small businessman the freedom to choose the type of business organization he desires without regard to tax consequences. As to the Government's contention that the voting trust created a "shareholder" other than an individual,[20] the court stated that it could "conceive of no reason why, either technically or by implication, a voting trust should be considered a shareholder under [section] 1371(a)(2)."[21] The court noted that 1371(a)(2) was directed toward limiting the number of shareholders of the corporation. While recognizing that a "normal" trust could create a type of business organization which would prohibit a corporation from making a subchapter S election,[22] the court concluded that since the trust in the instant case consisted of the original shareholders as beneficiaries, and added no block of additional shareholders as beneficiaries of the trust who could be considered shareholders of the plaintiff corporation, the 1371(a)(2) limit on the number of shareholders was not exceeded. In so holding,

19. The instant court stated that in such a situation each class of stock has a different value to the shareholder, concerning his proportionate right to distributiou of earnings or deduction of losses. Thus, the issuance of two different classes of stock by such a corporatiou would lead to accounting complications when the time came to determine what percentage of profits or losses was allocable to the different shares for tax purposes. The court also declared invalid Rev. Rul. 63-226, 1963-2 CUM. BULL. 341, cited by the Government in further support of its position. In that ruling the Commissioner held that a limited partnership which had assumed corporate form was not qualified for a subchapter S election because, when the two limited partners granted irrevocable proxies to the active partners to vote their stock, their action had the effect of creating two classes of stock.

20. *See* INT. REV. CODE of 1954, § 1371(a)(2). The Government's theory on this point was that the trustee-shareholder, in effect, had a "share" which contained all the voting rights, while the other shareholders have non-voting shares only. Therefore, the trust itself is a shareholder other than an individual, notwithstanding the fact that a voting trust is not an entity capable of holding stock. The Government supports this theory with Treas. Reg. § 1.1371-1(e) (1959). *See* note 5 *supra*.

21. 271 F. Supp. at 46.

22. The court reasoned that if a corporation were permitted to have as a shareholder another corporation, or a "normal trust," then it could seek to evade the limitation of only ten shareholders. In such a situation, all the shareholders of the corporation-shareholder would, in effect, be shareholders of the small corporation. Thus, the corporatiou would no longer be a "small" one, and no longer allowed to operate as a proprietorship for tax purposes. In supporting its conclusion that such a sitiation was not the case in the instant voting trust, the court distinguished Old Virginia Brick v. Commissioner, 367 F.2d 276 (4th Cir. 1966), involving an estate which was one of several shareholders of a subchapter S corporation. The court there found that the estate had become a testamentary trust because it had been held open beyond the time necessary for its administration. Thus the corporation was disqualified as a subchapter S corporation because in that particular case the trust had the effect of adding shareholders beyond the limit of ten.

the instant court struck down the application of Treasury Regulation section 1371-1(e) to voting trusts on the ground that it was inconsistent with the intent of subchapter S.[23]

Given the basic purposes of Congress in enacting subchapter S and the reasons for limiting election to corporations with less than ten shareholders,[24] it appears that the instant court's decision was a correct one. As to the "second class of stock" issue, certainly, the Commissioner has a legitimate area of concern in attempting to minimize the complexities involved in tax accounting. Where stock bears different rights as to dividends and liquidating distributions those complexities are such that the limitation of subchapter S benefits to corporations having only one class of stock is obviously justified. It is highly questionable, however, whether the differences in voting rights among shareholders give rise to the sort of accounting complexities which would be a valid basis for a denial of the right to election. The voting trust is essentially a method of business control and, consequently, does not entail such accounting intricacies. Therefore, a difference in the voting power or control of shares should be an insignificant factor. Control of voting rights by a trustee is not logically related to income allocation among trustor-shareholders since they still retain dividend rights which are unaffected by the trust agreement and which will yield an income proportionate to the number of shares in which the trustor-shareholders hold equitable title. If the Commissioner's contention that voting trusts did create a fatal second class of stock had been upheld, the instant court would have imposed a burdensome requirement upon close corporations since such corporations often depend upon voting trusts or other shareholder control agreements to facilitate business management.[25] However, the instant court has insured that subchapter S benefits will be available to close corporations operating with voting trusts.

23. The court noted here that there were no cases in point on either of the two issues presented in the case other than a dictum in Catalina Homes, Inc. v. Commissioner, 1964 P-H Tax Ct. Mem. ¶ 64,225. For purposes of subchapter S, the instant court stated that "it seemed clear that Congress did not intend" that a voting trust be considered a shareholder because the creation of a voting trust did not, and could not increase the size of the electing corporation, nor did it create accounting complications. Thus, said the court, to uphold Treas. Reg. § 1.1371-1(e) (1959) would be "to hold that a tax may be imposed by regulation, which of course the law does not permit." 271 F. Supp. at 47.

24. *See* notes 6-8 *supra* and accompanying text.

25. *See* ncte 6 *supra*.