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RECENT CASES

Antitrust–Unincorporated Divisions of a Corporation May Be Separate Entities for Purposes of Antitrust Laws

Plaintiff, a distributor of alcoholic beverages, brought an action for treble damages under Section 4 of the Clayton Act[1] against three unincorporated sales divisions of House of Seagram,[2] its parent corporation, Joseph E. Seagram and Sons, and two other corporations, contending that it was eliminated from the wholesale liquor business by a conspiracy in restraint of trade among defendants in violation of Section 1 of the Sherman Act.[3] The plaintiff requested a jury instruction that each of the unincorporated divisions be treated as a separate corporate entity, capable of conspiring with the other divisions in violation of the antitrust law. The United States District Court for the District of Hawaii, *held,* instruction granted. Where unincorporated divisions of a single corporation function on the same economic level and operate independently of one another in the relevant business activity, each is capable of conspiring with the others in violation of Section 1 of the Sherman Act. *Hawaiian Oke & Liquors, Ltd. v. Joseph E. Seagram & Sons, Inc.,* 272 F. Supp. 915 (D. Hawaii 1967).

Under Section 1 of the Sherman Act the showing of a "contract, combination . . . or conspiracy, in restraint of trade . . ." is necessary in order to prove a violation of the statute. As with all conspiracy offenses, violation of Section 1 requires that two or more persons or entities engage in the proscribed activity.[4] This requirement, although easily met in most cases, has proved difficult to satisfy in finding alleged violations of Section 1 among entities in a single corporate

1. 15 U.S.C. § 15 (1964).

2. Calvert Distillers Co., Four Roses Distillers Co., and Frankfort Distillers Co. are unincorporated divisions of House of Seagram, a wholly owned subsidiary of Joseph E. Seagram and Sons.

3. "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce among the several States . . . is hereby declared to be illegal." 15 U.S.C. § 1 (1964).

4. For a discussion of the development of conspiracy as used in § 1 and its relationship to the concept of "restraint of trade," see Rahl, *Conspiracy and the Anti-Trust Laws,* 44 ILL. L. REV. 743, 744-47 (1950). When the Sherman Act was formulated, restraint of trade was thought necessarily to involve two parties. At that time "[t]he danger lay not in concentration of power as a characteristic of the industrial order, but in the propensity of traders to associate or conspire." *Id.* at 746.

structure. In *United States v. General Motors Corp.*[5] a court for the first time upheld the finding of conspiracy between a parent corporation and its wholly owned incorporated subsidiaries under Section 1. The court stated that "[t]he test of illegality under the Sherman Act is not so much the particular form of business organization effected, as it is the presence or absence of restraint of trade and commerce."[6] As yet the courts have refused to find a vertical conspiracy between a parent corporation and its unincorporated divisions. The courts[7] which have faced this issue have relied on *Nelson Radio & Supply Co. v. Motorola*[8] which held that there could be no conspiracy between officers and employees of a single corporation, reasoning that since a natural person cannot conspire with himself, neither could a corporation. The precursor of the instant case is *Kiefer-Stewart v. Joseph E. Seagram & Sons, Inc.*,[9] an action based upon an alleged horizontal conspiracy between incorporated divisions of House of Seagram to fix resale prices by refusing to sell to plaintiff wholesaler. Finding a per se violation of Section 1 of the Sherman Act, the Court stated in *Kiefer-Stewart* that "common ownership and control does not liberate corporations from the impact of the antitrust laws," and emphasized that this rule is particularly applicable when the affiliates "hold themselves out as competitors."[10]

Noting that the case was the first action to present the courts with "an alleged horizontal conspiracy among the unincorporated divisions of a single corporation,"[11] the instant court stated two broad principles of antitrust law upon which its decision was based. First, Section 1 of the Sherman Act is "all-embracing," and covers "every"

5. 121 F.2d 376 (7th Cir. 1941), *cert. denied*, 314 U.S. 618 (1942). The four corporate defendants were charged with conspiracy to force G.M. dealers to finance their own purchases from the factory and their resales to consumers through General Motors Acceptance Corp. G.M. owned directly or indirectly all the stock of the other three defendants. The four corporations had interlocking directorates, and functioned as coordinated units of the large decentralized enterprise. *Id.* at 385-86.

6. *Id.* at 404. The following sentence reads: "But even if the single trader doctrine were applicable, it would not help the appellants." This could have one of two implications: first, that defendants could be found guilty under § 2, or second, that the principal concern here is restraint of trade, regardless of conspiracy. This last interpretation disregards the text of § 1.

7. Poller v. Columbia Broadcasting Sys., Inc., 284 F.2d 599 (D.C. Cir. 1960), *rev'd on other grounds*, 368 U.S. 464 (1962); Kemwel Automotive Corp. v. Ford Motor Co., 66 Trade Cas. ¶ 71,882 (S.D.N.Y. 1966); Deterjet Corp. v. United Aircraft Corp., 211 F. Supp. 348 (D. Del. 1962); Johnny Maddox Motor Co. v. Ford Motor Co., 202 F. Supp. 103 (W.D. Tex. 1960). These cases are all noted and distinguished by the instant court. 272 F. Supp. at 918-19.

8. 200 F.2d 911 (5th Cir. 1952).

9. 340 U.S. 211 (1951).

10. *Id.* at 215. *See* McQuade, *Conspiracy, Multicorporate Enterprises, and Section 1 of the Sherman Act*, 41 VA. L. REV. 183, 204-07 (1955).

11. 272 F. Supp. at 917.

form of combination which restrains trade. Second, the "rule of reason" should direct the court's discretion in determining whether, from the particular facts of the case, the statute has been violated. The court stated that it is "well settled" that there can be a conspiracy wihin a corporate structure consisting of a parent corporation and incorporated subsidiaries.[12] The court held that whether a particular unincorporated division is capable of conspiring depends on the facts of the case. If the divisions "operate independently" in conducting business activity upon which the conspiracy charge is based, then the divisions are to be regarded as separate entities for antitrust law purposes. The court closely examined the corporate structure of House of Seagram and determined that in the pertinent areas of distribution and pricing[13] the three divisions had always acted with complete independence.[14] The court concluded that such divisions are therefore "legally and factually capable of entering into the conspiracy alleged."[15]

As noted by the instant court, the policy of the antitrust laws includes promotion of competition through prevention of restraints of trade.[16] Where two or more enterprises combine to restrain trade they may be reached under Section 1 of the Sherman Act for a "conspiracy" in restraint of trade. A single enterprise which has an intent to monopolize, or engages in conduct creating a dangerous probability of monopoly may be attacked under Section 2 as an attempt to monopolize.[17] However, where two units of a multicorporate enterprise engage in anticompetitive activity not amounting to a Section 2 attempt to monopolize, the courts have hesitated to apply the Section 1 conspiracy concept. Under the present law the courts are faced with the alternatives of expanding the conspiracy concept, enlarging the scope of Section 2, or disregarding such restraints. Those who advocate the possibility of finding an intra-enterprise conspiracy feel that the form of the corporate structure should not prevail over the substance, in that certain entities are separate economic units

12. The court here cites Kiefer-Stewart Co. v. Joseph E. Seagram & Sons, Inc., 340 U.S. 211 (1951); Timken Roller Bearing Co. v. United States, 341 U.S. 593 (1951); United States v. Yellow Cab Co., 332 U.S. 218 (1947); and Phi Delta Theta Fraternity v. J. A. Buchroeder & Co., 251 F. Supp. 968 (W.D. Mo. 1966). 272 F. Supp. at 919 n.11.

13. Marketing is the only activity which the court considered for a determination of the individual status of these divisions as competitors.

14. The court noted that the divisional responsibility had changed only slightly since Seagram was convicted of a similar antitrust violation in *Kiefer-Stewart*. In fact, defendant's counsel admitted that the form of corporate structure had been changed solely to avoid this type of prosecution. 272 F. Supp. at 920 n.17.

15. *Id.* at 924.

16. *Id.* at 917.

17. American Tobacco Co. v. United States, 328 U.S. 781 (1946); Swift Co. v. United States, 196 U.S. 375 (1905).

organized and managed as competitors.[18] The principal criticism[19] of the doctrine is that it ignores the realities of conducting business in the modern corporate form. Many corporations have adopted the subsidiaries or divisions structure to take advantage of the concept of decentralized management made popular by General Motors. Others seek to insulate the parent from possible liability for losses suffered by the subsidiary. Additional motivations include tax avoidance and compliance with various state laws. None of these purposes relate to the entities' capacities as competitors. However, once a court rejects the arguments opposing the finding of an intra-enterprise conspiracy it must develop guidelines to determine whether entities are capable of conspiring. The criteria used by the instant court are the functional independence of each division in the pertinent economic activity (sales and distribution), the presence of competition between similar brands marketed by each division, and the lack of any vertical direction from the parent company. The court said that the pertinent inquiry is whether "each facet of the unincorporated division's operation in fact, for all purposes, [is] controlled and directed from above, or is it endowed with separable, self-generated and moving power to act in the pertinent area of economic activity."[20] If units of a multi-division enterprise do in fact operate autonomously of other divisions and do not receive direction from the parent company, it is plausible for courts to treat them as separate economic units susceptible to allegations of conspiracy. This refinement of the intra-enterprise conspiracy doctrine limits its application to a small minority of corporate structures and seems to contain within it a method to avoid its application. Since a court must rely on corporate history to determine the degree of integration of activity among corporate divisions and the degree of control exerted by their parent company, an enterprise could produce records of consultation and directives from the parent evidencing a lack of independence. Thus, the guidelines promulgated by the instant court, while seeking to ground capacity to conspire in economic reality, severely restrict the application of the intra-enterprise conspiracy doctrine and make the finding of separate entity status difficult.

18. This argument necessarily applies only to horizontal units in a corporate structure since the finding of a parent-subsidiary conspiracy would not involve competition between the two entities. The instant court makes this distinction.

19. *See* Oppenheim, *Federal Antitrust Legislation: Guideposts to a Revised National Antitrust Policy*, 50 MICH. L. REV. 1139, 1170-71 (1952); Rahl, *supra* note 4, at 762-68; REPORT OF THE ATTORNEY GENERAL'S NATIONAL COMMITTEE TO STUDY ANTITRUST LAWS 34-36 (1955). *Contra*, Note, *Intra-Enterprise Conspiracy Under the Sherman Act*, 63 YALE L.J. 372, 387-88 (1954).

20. 272 F. Supp. at 920.

Constitutional Law—One-Year Residence Requirement as Condition of Eligibility for State Welfare Aid Held Unconstitutional

Plaintiff was denied welfare benefits under the Connecticut Aid to Families with Dependent Children (AFDC) program on the ground that she failed to satisfy the Connecticut welfare statute's requirement that persons coming into the state without visible means of support must fulfill a one-year residency in order to qualify for payments.[1] Plaintiff alleged that the statute was unlawfully discriminatory[2] and abridged her right of interstate travel in violation of the fourteenth amendment. Connecticut contended that the residence requirement was necessary to protect the state from the financial burden that would result from an undeterred influx of indigents into the state and that the statute did not deprive the plaintiff of the right to travel or to settle in Connecticut but merely denied her welfare benefits for one year. On trial before a three-judge panel in the federal district court for the District of Connecticut, *held*, judgment for the plaintiff. Denying welfare benefits to persons entering the state without visible means of support until such persons have resided in the state for one year violates the constitutional right of interstate travel and the equal protection clause of the fourteenth amendment. *Thompson v. Shapiro*, 270 F. Supp. 331 (D. Conn. 1967).[3]

The states have based their authority to impose residence requirements as prerequisites to eligibility for welfare upon the contention

1. CONN. GEN. STAT. § 17-2d (Supp. 1965) provides that: "When any person comes into this state *without visible means of support for the immediate future* and applies for aid to dependent children . . . within one year from his arrival, such person shall be eligible only for temporary aid or care until arrangements are made for his return, provided ineligibility for aid to dependent children shall not continue beyond the maximum federal residence requirement." (Emphasis added). The Social Security Act, 42 U.S.C. § 602(b) (1964), limits the residence requirement to one year. Regulations of the Connecticut Welfare Department construe the term "without visible means of support" to mean without specific employment or without sufficient resources to enable the family to be self-supporting. The term "immediate future" is interpreted to mean within three months after arrival in the state. *See* CONNECTICUT WELFARE MANUAL, ch. II, § 219.1, cited in Thompson v. Shapiro, 270 F. Supp. 331, 333 (D. Conn. 1967). The effect of § 17-2d is to withhold aid to dependent children for one year to newly-arrived residents unless they come into the state with substantial employment prospects or certain financial resources. *See* CONNECTICUT WELFARE MANUAL, ch. II, § 219.2, cited in 270 F. Supp. at 334.

2. Plaintiff contended that Connecticut discriminated against her in favor of newly-arrived residents with employment, newly-arrived residents with a cash stake, and residents of one year's duration.

3. In Harrell v. Tobriner, 36 U.S.L.W. 2283 (D.D.C. Nov. 8, 1967), the court held that an indigent mother's constitutional rights to travel and to equal protection of the laws invalidated the District of Columbia welfare statute's one-year residence requirement.

that the receipt of welfare benefits is a privilege granted by the state and not a right of citizenship.[4] The rationale for these requirements is that the receipt of welfare, being merely a privilege, may be subject to reasonable qualifications, one of which is the imposition of a residence test which is necessary to protect state welfare funds. This argument follows the traditional dichotomy between the terms right and privilege.[5] While possession of a right signifies the possessor's exemption from governmental power to alter his legal relations, the possession of a privilege may be qualified by the grantor of the privilege. This right-privilege distinction, however, does not avoid the broad scope of the equal protection clause of the fourteenth amendment which forbids the laws of a state, whether relating to rights or privileges, to deny equal protection to any person within the state.[6] Residence requirements have been attacked on two grounds: they deny the newly-arrived citizen the equal protection of the laws of the state and they abridge a citizen's constitutional right to interstate travel and to establish residence in the state of his choice. The Supreme Court has stated that the equal protection clause of the fourteenth amendment prohibits "undue favor and individual or class privilege, on the one hand, and . . . hostile discrimination or the oppression of inequality, on the other. It . . . [seeks] an equality of treatment of all persons . . ."[7] and state regulations must "operate alike upon all persons . . . under the same circumstances and conditions."[8] Despite these pronouncements, the Court has recognized that the right to equal protection of the law is not an absolute right. The Court has conceded that while the equal protection clause requires uniform application of laws to all persons similarly situated, the legislature is allowed wide discretion in the selection of certain classes of people upon whom it imposes operation of its statutes.[9] This selection, in order to be violative of the equal protection clause, must be clearly arbitrary and unreasonable.[10]

4. In Harrell v. Board of Commissioners, 269 F. Supp. 919, 921 (D.D.C. 1967), the court stated that welfare aid is a grant, "not the fulfillment of a contractual obligation." *See also* People *ex rel.* Heydenreich v. Lyons, 374 Ill. 557, 30 N.E.2d 46 (1940), where the Illinois Supreme Court upheld a residence test on the ground that since the state had no duty to furnish welfare it could impose restrictions on aid in order to protect state funds.

5. For a discussion of these terms see HOHFELD, FUNDAMENTAL LEGAL CONCEPTIONS 5-8 (W. Cook ed. 1923).

6. The Supreme Court has traditionally recognized that both rights and privileges are protected by the equal protection clause. *See, e.g.*, Slaughter-House Cases, 83 U.S. (16 Wall.) 36 (1873); Strauder v. West Virginia, 100 U.S. 303 (1879).

7. Truax v. Corrigan, 257 U.S. 312, 332-33 (1921).

8. Barbier v. Connolly, 113 U.S. 27, 31-32 (1885).

9. Barrett v. Indiana, 229 U.S. 26 (1913).

10. Phelps v. Board of Educ., 300 U.S. 319 (1937); Smith v. Calhoon, 283 U.S.

Following these principles, the Court has not granted all persons an absolute equality and has permitted unequal state treatment of various classes of persons[11] subject to the limitation that a state's discrimination between classes of persons is valid only if " 'the classifications drawn in a statute are reasonable in light of its purpose.' "[12] The Court has further qualified the validity of such classifications by stating that disparate treatment may not be justified because of some remote administrative benefit to the state.[13] In conformity with this line of reasoning, the federal district court of Delaware in the recent case of *Green v. Department of Public Welfare*[14] held that a one-year residence requirement created "an invidious distinction" in violation of the equal protection clause and stated that protection of the public purse by discouraging needy persons from entering the state "is not a permissible basis for differentiating between persons who otherwise possess the same status in their relationship to the [s]tate . . . ."[15]

The second ground upon which state residence requirements for welfare recipients have been attacked is that of the right of interstate travel. While the right to travel, once its legal basis is established, is not exempt from limitations, it is also within the purview of the equal protection clause, and state regulations covering that right cannot treat different classes of persons unequally without a reasonable basis for the discrimination. The constitutional source of the right of

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533, 566-67 (1931); Frost v. Corporation Comm'n, 278 U.S. 515, 522 (1929); Bachtel v. Wilson, 204 U.S. 36 (1907).

11. Borden's Farm Prods. v. Ten Eyck, 297 U.S. 251 (1936); Ohio *ex rel.* Clarke v. Deckebach, 274 U.S. 392 (1927) (both cases involved state regulations of business). Some state courts have justified restraints against indigents as a reasonable means of attaining what is a proper objective of police power. *See* Brown, *Due Process of Law, Police Power, and the Supreme Court*, 40 HARV. L. REV. 943 (1927). Earlier state court decisions have upheld the removal of indigents on the ground that paupers, being dependent on public funds, constitute a special class which must be subject to legislative control. *See* Harrison v. Gilbert, 71 Conn. 724, 43 A. 190 (1899); Town of Bristol v. Town of Fox, 159 Ill. 500, 42 N.E. 887 (1896); Lovell v. Seeback, 45 Minn. 465, 48 N.W. 23 (1891). The passage of time since these decisions and the change in social and economic conditions has probably diminished their authoritative weight and relevancy.

12. Carrington v. Rash, 380 U.S. 89, 93 (1965), *quoting from* McLaughlin v. Florida, 379 U.S. 184, 191 (1964). *See also* Allied Stores v. Bowers, 358 U.S. 522, 527-28 (1958), and cases cited therein.

13. Carrington v. Rash, 380 U.S. 89, 96 (1965). *See also* Oyama v. California, 332 U.S. 633, 646-47 (1948), and Harvith, *The Constitutionality of Residence Tests for General and Categorical Assistance Programs*, 54 CAL. L. REV. 567, 597 (1966).

14. 270 F. Supp. 173 (1967).

15. *Id.* at 177 (1967). *See also* Harrell v. Tobriner, 36 U.S.L.W. 2283 (D.D.C. Nov. 8, 1967), where the court stated that a bona fide resident of District of Columbia for six months who was indigent and without means to support herself and her children was no less in need of public support than an indigent who had been in the District of Columbia for a full year.

interstate travel, however, has not been clearly identified and remains uncertain. Prior to the adoption of the fourteenth amendment, the Supreme Court indicated in *Crandall v. Nevada*[16] that the right of interstate travel is an incident of national citizenship which cannot be abridged by the states. While subsequent Supreme Court decisions concerning the interstate movement of persons[17] have involved direct restrictions of a commercial nature, which have been found to violate the commerce clause,[18] some Justices have asserted that the right of interstate travel discussed in *Crandall* has become embodied in the privileges and immunities clause of the fourteenth amendment. In *Edwards v. California*,[19] where five members of the Court held a state restriction upon the transportation of nonresident indigents into the state invalid under the commerce clause, Mr. Justice Douglas, concurring, stated that the case could have been more properly decided under the privileges and immunities clause.[20] He believed that state statutes obstructing interstate travel are invalid on the basis of concepts of national unity, the democratic system of govern-

16. 73 U.S. (6 Wall.) 35, 43-44 (1867), where a state tax on all persons leaving the state by commercial vehicle was invalidated because it inhibited the federal government's need of a freely mobile citizenry and the corresponding right of citizens to free access to all seats of government. The Supreme Court has frequently asserted in dicta that the privileges of national citizenship include the right to pass freely through and reside in any state; *e.g.*, Meyer v. Nebraska, 262 U.S. 390, 399 (1923); Twining v. New Jersey, 211 U.S. 78, 97-98 (1908); Slaughter-House Cases, 83 U.S. (16 Wall.) 36, 79-80 (1872); and that this right is protected against state abridgement by the privileges and immunities clause of the fourteenth amendment; *e.g.*, William v. Fears, 179 U.S. 270, 274 (1900); Allgeyer v. Louisiana, 165 U.S. 578, 589 (1897).

17. The Supreme Court has consistently held that the interstate movement of persons is interstate commerce; *e.g.*, Caminetti v. United States, 242 U.S. 470, 491 (1917); Hoke v. United States, 227 U.S. 308, 320 (1913); Leisy v. Hardin, 135 U.S. 100, 112 (1890).

18. The Supreme Court has held that a state is without power to impose a tax on persons for securing or seeking to secure the transportation of freight or passengers in interstate commerce. Helson & Randolph v. Kentucky, 279 U.S. 245, 251 (1929) (Kentucky tax on fuel used in interstate ferry boats held violative of commerce clause); McCall v. California, 136 U.S. 104, 109 (1890) (license tax imposed on railroad agent for soliciting passengers for interstate travel held unconstitutional tax on interstate commerce); Pickard v. Pullman Southern Car Co., 117 U.S. 34, 46, 48 (1886) (Tennessee tax on sleeping cars used in interstate commerce held void as applied to interstate transportation of passengers; tax was on right of transit). *See also* People v. Compagnie Generale Transatlantique, 107 U.S. 59 (1882); Henderson v. Mayor of New York, 92 U.S. 259 (1875); Passenger Cases, 48 U.S. (7 How.) 282 (1849). All three cases held that state tax demanded of master of vessel for every alien passenger was unconstitutional state regulation of commerce.

19. 314 U.S. 160, 176 (1941).

20. Justices Black and Murphy concurred in the opinion by Mr. Justice Douglas, 314 U.S. at 177, and Mr. Justice Jackson concurred separately, 314 U.S. at 181. The majority expressed no view contrary to the proposition that freedom of movement is a privilege of national citizenship protected by the privileges and immunities clause, finding it unnecessary to reach that question. 314 U.S. at 177.

ment, and the mobility which is basic to the guarantee of freedom of opportunity.[21] Mr. Justice Jackson, also concurring, noted that although freedom of interstate movement is not unlimited, indigence is not a valid reason for restricting that movement.[22] Later, in *Guest v. United States*,[23] the Court, although failing to identify the source of the right, held that freedom of interstate movement is recognized and protected under the Constitution. However, in *Harrell v. Board of Commissioners*,[24] a District of Columbia district court refused to apply the rationale of these earlier cases to residence requirements of a state welfare statute and stated that "[t]he suggestion that such a residence requirement interferes with the freedom of travel . . . is . . . far-fetched and remote."[25]

A thorough consideration of a particular welfare program must not disregard the underlying principles and the objectives of American social welfare legislation. American welfare programs can be separated into two types: measures whose purpose is income maintenance of impoverished or unemployed persons; and measures whose purpose is the reabsorption of unemployed into the labor market.

21. Mr. Justice Douglas stated: "If a state tax on that movement, as in the *Crandall* case, is invalid, a *fortiori* a state statute which obstructs or in substance prevents that movement must fall. That result necessarily follows unless perchance a State can curtail the right of free movement of those who are poor or destitute. But to allow such an exception to be engrafted on the rights of national citizenship would be to contravene every conception of national unity. It would also introduce a caste system utterly incompatible with the spirit of our system of government. It would permit those who were stigmatized by a State as indigents, paupers, or vagabonds to be relegated to an inferior class of citizenship. It would prevent a citizen because he was poor from seeking new horizons in other States. It might thus withhold from large segments of our people that mobility which is basic to any guarantee of freedom of opportunity. The result would be a substantial dilution of the rights of *national* citizenship, a serious impairment of the principles of equality." 314 U.S. at 181.

22. "[A] man's mere property status, without more, cannot be used by a state to test, qualify, or limit his rights as a citizen of the United States. 'Indigence' in itself is neither a source of rights nor a basis for denying them. The mere state of being without funds is a neutral fact—constitutionally an irrelevance, like race, creed, or color." Edwards v. California, 314 U.S. 160, 184-85 (1941).

23. 383 U.S. 745 (1966). In upholding an indictment based on 18 U.S.C. § 241 (1964), which forbids conspiracy to interfere with rights or privileges secured by the Constitution, the Court stated that if the object of the conspiracy was to impede a citizen's exercise of his right to interstate travel, then the conspiracy is subject to federal prosecution. *Id.* at 760. *See also* the concurring opinion of Justices Douglas and Goldberg in Bell v. Maryland, 378 U.S. 226, 250-51, 255 (1964), indicating that state action is unconstitutional even if it merely hinders interstate movement.

24. 269 F. Supp. 919 (D.D.C. 1967). The court held that public assistance is a grant, not the fulfillment of a contractual obligation, and that the imposition of a residence requirement as a prerequisite to the receipt of a public grant was reasonable since it is within the discretion of Congress to surround grants of public assistance with reasonable requirements and prescribe the categories of persons to whom the grants shall be given.

25. *Id.* at 921.

This separation is based on the distinction between those needy persons for whom only programs of alleviation are feasible and the impoverished for whom curative programs are appropriate.[26] The curative programs[27] which provide job training and opportunity rather than mere subsistence income are aimed at eliminating the cause of poverty and unemployment, whether it be lack of training, education and experience, or displacement. These programs are generally regarded as more beneficial to both the individual, who is given the opportunity to achieve self-reliance, and to society, which benefits from the individual's productive capability and spending as a wage-earner. Alleviative programs,[28] on the other hand, which take the form of income maintenance for impoverished groups, neither stimulate self-reliance nor encourage the recipient to become a producer. The cost of these programs to society often exceeds the benefits except in the case of insurance-type programs,[29] which are funded by taxation of the past earnings of the recipients. The strength of society's inclination to establish a particular program will depend upon the relative importance attached to the two principal objectives of aid programs: help for the impoverished individual or stimulation of the economy. The first objective is generally considered primary, due to the concern in American society for the dignity of the individual and for the unemployed worker as a human being as well as a potential contributor to the economy. However, these concerns must be balanced against the aid program's possible deterrent effect on the recipient's initiative and the need to protect the economic interests of the rest of the population whose incomes may be reduced as a result of the taxation needed to fund such programs. In the case of Aid to Families with Dependent Children, this concern for the cost to society is important because the recipients will not be able to contribute to the economy other than by spending the benefit payments. Balanced against this cost factor is the paramount national interest in children as potential contributors to society.

In the instant case, the court noted that although the constitutional source of the right of interstate travel is uncertain and has been the subject of much debate, the existence of that right is unquestionable. Stating that "the right of interstate travel embodies not only the right to pass through a state but also the right to establish residence

26. IN AID OF THE UNEMPLOYED 290 (J. Becker ed. 1965). *See generally id.* at 275-79, 290-92.

27. Curative programs include the Economic Development Act, Area Redevelopment Act, Neighborhood Youth Corps, Manpower Development and Training Act, and Office of Economic Opportunity.

28. These programs include Aid to Families with Dependent Children, Veterans' Administration, and Old Age, Survivors, and Disability Insurance.

29. These programs include Social Security and Unemployment Compensation.

therein,"[30] the court reasoned that choice of residence is not subject to local approval, and that indigence cannot be employed as a basis for the limitation of one's rights.[31] Relying on *Guest,* the majority stated that the Constitution proscribed the abridgement of the right of interstate travel and found that the Connecticut statute had a chilling effect on the exercise of the right to travel through and reside in that state.[32] In addition, the court found that the Connecticut statute also denied plaintiff equal protection of the laws. Stating that when the government grants relief to some "it must justify its denial to others by reference to a constitutionally recognized reason,"[33] the majority concluded that the statute's intended purpose of protecting the state treasury by discouraging the entry into the state of persons needing relief was not a valid reason for the discriminatory denial of welfare aid to newcomers.[34] The one-year residence classification was held unreasonable because the state failed to show that any significant number of newly-arrived residents come to the state for the purpose of receiving welfare aid; and the discrimination against those who enter without visible means of support was unreasonable because there was no showing that in the long run the applicant with the cash stake would be a lesser drain on the state treasury. While suggesting that if the Connecticut time-limit were equally applied to all welfare recipients "for the purpose of prevention of fraud, investigation of indigency or other reasonable administrative need, it would undoubtedly be valid,"[35] the court emphatically asserted that even a residence requirement designed to deny aid to all newcomers entering the state solely to seek welfare benefits would be invalid. The dissenting judge contended that the Connecticut residence requirement was a reasonable restriction directly related to the problem sought to be remedied. He pointed out that forty states had established residence tests as a qualification for the receipt of AFDC, and that Congress had sanctioned such

30. 270 F. Supp. at 336.

31. *Id.* The court here quoted from Mr. Justice Jackson's concurring opinion in Edwards v. California, 314 U.S. 160, 185 (1941): "Property can have no more dangerous, even if unwitting, enemy than one who would make its possession a pretext for unequal or exclusive civil rights. Where those rights are derived from national citizenship no state may impose such a test. . . ."

32. *Id.* Drawing an analogy to the "chilling doctrine" under the first amendment the court here cited Dombroski v. Pfister, 380 U.S. 479, 487 (1965); Wolff v. Selective Serv. Bd. No. 16, 372 F.2d 817 (2d Cir. 1967).

33. 270 F. Supp. at 338.

34. In Harrell v. Torbriner, 36 U.S.L.W. 2283 (D.D.C. Nov. 8, 1967), the court held that a District of Columbia one-year residence requirement denied a six-month resident equal protection of the law because the different treatment of one-year residents and residents of less than one year had no reasonable relation to the basic legislative purpose of the welfare statute.

35. 270 F. Supp. at 338.

requirements by enacting the Social Security Act. The dissent distinguished *Edwards* from the present case on the ground that the California statute actually limited the right of citizens to travel freely between the states, whereas the Connecticut statute did not limit interstate travel but only deterred those who would enter the state for the primary purpose of receiving welfare. In equally classifying all non-residents who entered Connecticut and applied for welfare aid within one year, it was maintained that the legislature had legitimately exercised its police power. The dissent concluded that without such a statutory deterrent, Connecticut would be powerless to prevent its becoming a refuge for needy persons from other states whose welfare payments were less than those for Connecticut.

The instant court's assertion that even a residence requirement denying aid to those entering the state solely to seek welfare benefits would be invalid[36] appears to be both a recognition of the national interest in the free movement of employable persons and an accurate application of the Supreme Court's criterion that classifications drawn in a statute must be reasonable in light of the statute's purpose. The Supreme Court has accepted the appeal of the instant case[37] and will therefore have an opportunity to set standards for balancing the rights of equal protection and interstate travel against the practical necessity for some administrative procedure whereby state welfare funds can be effectively and fairly distributed to those in need, and, at the same time, protected from possible fraudulent claims and unjustified burdens imposed by large numbers of nonresident indigents. In light of the fact that forty states[38] have established one-year residence requirements as conditions for eligibility for aid to dependent children, affirmance by the Supreme Court will require those states to devise some alternative measure designed both to satisfy the administrative and financial needs of the states and to protect the rights of the individual. Many factors involved in the implementation of American welfare programs should be considered by the Supreme Court in its disposition of the instant case. The financial and administrative interests of the state require recognition of the fact that when a government grants benefits to which citizens do not have a right it needs such power as is necessary and proper to supervise its largess.[39] Moreover, the merit of welfare and the needs of recipients should not completely override concern for the economic

36. In Harrell v. Tobriner, 36 U.S.L.W. 2283 (D.D.C. Nov. 8, 1967), the court stated that the possibility that some citizens enter the District in order to obtain greater welfare aid was not sufficient to require a residence requirement, which the court stated was a "constitutionally impermissible basis for separate state treatment."

37. Thompson v. Shapiro, 36 U.S.L.W. 3214 (D. Conn. Nov. 13, 1967).

38. 270 F. Supp. at 339 n.1.

39. *See* Reich, *The New Property*, 73 YALE L.J. 733, 746 (1964).

interests of the taxpaying citizens whose incomes are reduced as a result of welfare. The concern for equal protection should recognize the distinction between requirements necessitated by limited monetary funds and qualifications such as race and ancestry "which rest upon a closed, fixed class or involuntary status."[40] Criticism of the conditions imposed on the receipt of welfare benefits should consider the purposes of the conditions, the relevance and availability of direct regulatory power,[41] and the governmental interest in the reduction of the cost of its programs. Connecticut's argument that the residence requirement was necessary in order to maintain the cost of AFDC at reasonable levels was unacceptable because the state estimated that the indigents who would enter Connecticut in the absence of the residence test would increase the cost of AFDC by only two per cent.[42] Nevertheless, where there is a substantial increase in cost, this factor should be highly relevant in the evaluation of a condition necessitated by limited financial resources. The inherent distinction between curative and alleviative aid programs and the alternative methods of financing welfare also have an important bearing upon the validity of conditions imposed upon the receipt of aid. While the curative programs attempt to eliminate the cause of poverty and make the recipient a self-reliant contributor to the economy, the alleviative programs, such as AFDC, result in an undesirable reliance by the recipient upon the government, and make the recipient a contributor only to the extent that he consumes the benefit payments. Society may realize short-term benefits from the training of unemployed in curative programs; but the benefits from the alleviative support of dependent children will not be realized until the children reach working age. Providing income through the creation of jobs is economically preferable to the long-term cost to society of cash assistance, and is a strong argument for imposing strict limitations upon income maintenance programs such as AFDC. Nonetheless, such restrictions must bear a reasonable relation to the purposes of the program.

40. O'Neil, *Unconstitutional Conditions: Welfare Benefits with Strings Attached,* 54 CAL. L. REV. 443, 449 (1966).

41. *Id.* at 453-56.

42. 270 F. Supp. at 337 n.4.

International Law—Sovereign Immunity and Act of State—Hickenlooper Amendment Precludes Assertion of Act of State Where Act Is Violative of International Law

In 1958 the defendant, a New York banking corporation, lent a Cuban governmental corporation fifteen million dollars, secured by United States government bonds and other obligations. After the ascension of the Castro regime in 1959 the loan was renewed, but the following year the Cuban Government confiscated defendant's branches in Cuba.[1] Shortly thereafter the bank sold the collateral, realizing approximately 1,800,000 dollars in excess of the amount of the loan. Plaintiff, the successor of the Cuban corporation, brought suit against the bank in federal district court to recover the excess.[2] Claiming the Cuban Government was the real party in interest, the defendant pleaded its seized property as a set-off and entered an affirmative counterclaim for the excess of the value of that property over the amount of plaintiff's claim. Plaintiff contended that both the set-off and the counterclaim were barred by the principle of sovereign immunity[3] or, alternatively, by the act of state doctrine.[4] On defendant's motion and plaintiff's cross-motion for summary judgment, *held*, plaintiff's cross-motion denied. By instituting an action in a United States court, a foreign sovereign waives immunity to a set-off, and, although the defendant's claim arises from a public act of the sovereign, the Hickenlooper Amendment[5] directs that the act of state doctrine will not preclude a determination on the merits if the acts in question were in violation of international law. *Banco Nacional de Cuba v. First Nat'l City Bank of New York*, 270 F. Supp. 1004 (S.D.N.Y. 1967).

The principles of sovereign immunity and act of state have under-

1. *See* Banco Nacional de Cuba v. First Nat'l City Bank, 270 F. Supp. 1004, 1009 n.6 (S.D.N.Y. 1967), quoting relevant portions of the confiscatory decree.

2. Plaintiff filed a second claim for deposits of various nationalized Cuban banks which had maintained accounts with defendant prior to their nationalization. The court summarily dismissed this complaint holding that it would not give extra-territorial effect to an act of state which was inconsistent with the policy and law of the United States. *Id.* at 1011.

3. Sovereign immunity is a jurisdictional principle of international law restraining a court from entertaining jurisdiction over a foreign state or its property. It was first stated in American courts, The Sehooner Exchange v. McFaddon, 11 U.S. (7 Cranch) 116 (1812), where it has since undergone modification.

4. "Every sovereign state is bound to respect the independence of every other sovereign state, and the courts of one country will not sit in judgment on the acts of the government of another done within its own territory." Underhill v. Hernandez, 168 U.S. 250, 252 (1897).

5. Foreign Assistance Act of 1964, § 301(d)(4), *as amended*, 22 U.S.C. § 2370 (e)(2) (Supp. 1966).

gone parallel developments in American jurisprudence: while each initially served as an absolute bar to relief against a sovereign or to a suit based on a sovereign's acts, today neither principle will necessarily be effective unless the executive branch suggests its application. In *Republic of Mexico v. Hoffman*[6] the United States Supreme Court refused to grant sovereign immunity because of the State Department's previous failure to suggest immunity in similar situations. The State Department's silence raised the implication that foreign policy did not require a grant of immunity,[7] and whether immunity ultimately should be granted was left to judicial interpretation. In 1952 the State Department announced that it would henceforth recommend immunity only for public acts of a government (*jure imperii*) and not for those governmental acts of a primarily private or commercial nature (*jure gestionis*).[8] In *National City Bank v. Republic of China*,[9] a case which allowed relief against the sovereign on a counterclaim for defaulted treasury notes, the Supreme Court amplified this trend toward more limited application of sovereign immunity by establishing a judicial presumption against immunity whenever the State Department did not suggest its application.[10] The *Republic of China* case was further significant in that it was the first to allow a counterclaim for matter unrelated to the sovereign plaintiff's claim. Since that case, courts have uniformly allowed both compulsory and permissive counterclaims, but have limited defendants to set-off relief,[11] and only a New York State lower court, in *Et ve Balik Kurumu v. B.N.S. Int'l Sales Corp.*,[12] has permitted a defendant's affirmative counterclaim to exceed the amount sought by the sovereign plaintiff.

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6. 324 U.S. 30 (1945). Immunity from a libel was denied to a merchant vessel owned but not possessed by the Mexican Government.

7. The prevention of judicial interference in the area of foreign policy is a common basis of both the sovereign immunity and act of state doctrines. *See* Maier, *Sovereign Immunity and Act of State: Correlative or Conflicting Policies?*, 35 U. CINN. L. REV. 556 (1966).

8. 26 DEP'T STATE BULL. 984 (1952). This pronouncement is known as the Tate Letter. The purpose of the letter (though it acknowledged the State Department's inability to dictate law to the courts) was to hold foreign nations to standards of commercial law in their dealings with American businessmen.

9. 348 U.S. 356 (1955). The American bank had counterclaimed for affirmative relief in addition to set-off, but abandoned the former after an adverse decision in the court of appeals, 208 F.2d 627 (2d Cir. 1953).

10. Maier, *supra* note 7, at 562.

11. *See* note 9 *supra*.

12. 25 Misc. 2d 299, 204 N.Y.S.2d 971 (Sup. Ct. 1960), *aff'd*, 17 App. Div. 2d 927, 233 N.Y.S.2d 1013 (1962). A governmeutal agency of Turkey sought damages for breach of contract and unjust enrichment. The court, in allowing the private defendant's affirmative counterclaim (arising from the same subject matter as plaintiff's claim), noted that the *Republic of China* case was not controlling since there the defendant had abandoned its claim for affirmative relief before the Supreme Court.

The act of state doctrine is a national principle of judicial restraint. But unlike sovereign immunity, which is a bar to jurisdiction, act of state is usually asserted after the court has assumed jurisdiction. Formerly it was automatically applied to bar adjudication where the asserted claim was based on the internal acts of a foreign sovereign. In what is known as the first *Bernstein* case,[13] Judge Learned Hand applied the doctrine in refusing to adjudicate the validity of acts of the then-defunct Nazi government. In the second *Bernstein* case,[14] the State Department intervened and communicated to the court that the foreign policy of the United States did not require the application of the act of state doctrine.[15] In then refusing to apply the doctrine, the court created the "*Bernstein* exception"[16]—the presumption that, unless the State Department indicated otherwise, the act of state doctrine would be applied.[17] Further liberalization occurred in *Banco Nacional de Cuba v. Sabbatino*,[18] in which the federal district court denied relief to the plaintiff sovereign on the ground that its claim of title to allegedly converted goods was based upon a confiscatory decree which was patently violative of international law. Regarding act of state as a domestic conflict of laws principle grounded in the recognition of and respect for the territorial sovereignty of each state, the district court felt that the basis for such recognition and respect vanished when the act of a foreign sovereign violated not only domestic notions of policy, but also standards of international law.[19] Furthermore, the court held that since the United States had notified the Cuban Government that the confiscations were illegal by international standards, there was no danger of embarrassing the executive branch in its conduct of foreign relations.[20] However, after the court of appeals affirmed this liberal-

13. Bernstein v. van Heyghen Freres, S.A., 163 F.2d 246 (2d Cir. 1947), *cert. denied*, 332 U.S. 772 (1947). The plaintiff Bernstein, a German national, had been forced by the Nazis to sell certain of his ships to a German Government trustee who later resold them to the defendant.

14. Bernstein v. N. V. Nederlandsche-Amerikaansche Stoomvaart-Maatschappij, 210 F.2d 375 (2d Cir. 1954).

15. *Id.* at 375-76.

16. For the argument that the *Bernstein* letter created no exception to the act of state doctrine, see Reeves, *The Sabbatino Case and the Sabbatino Amendment: Comedy—or Tragedy—of Errors*, 20 VAND. L. REV. 429, 440 (1967). The author argues that the State Department's letter merely advised the court as to what were the present existing laws in Germany at the time the case was before it. If the plaintiff had won the case instead of settling it, says Reeves, it would have been for reasons other than an exception to act of state. *Id.* at 442.

17. Maier, *supra* note 7, at 561.

18. 193 F. Supp. 375 (S.D.N.Y. 1961), *aff'd*, 307 F.2d 845 (2d Cir. 1962), *rev'd*, 376 U.S. 398 (1964).

19. The confiscations were held to violate international law because they were retaliatory, discriminatory, and without compensation. 193 F. Supp. at 384-86.

20. *Id.* at 381.

ization[21] the Supreme Court reversed,[22] returning to the rigid position requiring application of the act of state doctrine in the absence of a State Department suggestion to the contrary, and even casting doubt on the "*Bernstein* exception."[23] In reaction to the Supreme Court's decision, Congress, in 1964, enacted the so-called Hickenlooper Amendment,[24] which effectively overruled the Supreme Court's decision in *Sabbatino* by directing the courts to apply the doctrine only upon executive suggestion or where there appeared to be no violation of international law. The amendment was found to be constitutional when applied in the remand of the *Sabbatino* case, *Banco Nacional de Cuba v. Farr*.[25]

Speaking first to the issue of sovereign immunity, the court[26] in the instant case noted at the outset that Banco Nacional and the Cuban Government were identical for the purposes of this suit. The court based its decision on the "ultimate policy" of fairness, and, following the *Republic of China*[27] case, held that the plaintiff, by initiating proceedings in the district court, had waived immunity from counterclaims to the extent they did not exceed the amount of the plaintiff's claim. Addressing the act of state issue, the court acknowledged the supersession of the Supreme Court's *Sabbatino* decision by the Hickenlooper Amendment, which permitted the court to examine the legality of the Cuban Government's acts. To the court the confisca-

21. 307 F.2d 845 (2d Cir. 1962).

22. 376 U.S. 398 (1964).

23. *Id.* at 436.

24. Foreign Assistance Act of 1964, § 301(d)(4), *as amended,* 22 U.S.C. § 2370 (e)(2) (Supp. 1966), which reads in relevant part: "Notwithstanding any other provision of law, no court in the United States shall decline on the ground of the federal act of state doctrine to make a determination on the merits giving effect to principles of international law in a case in which a claim of title or other right is asserted by any party including a foreign state (or a party claiming through such state) based upon (or traced through) a confiscation or other taking after January 1, 1959, by an act of that state in violation of the principles of international law, including the principles of compensation and other standards. . . ." Also called the Sabbatino Amendment, or Rule of Law Amendment, the original version was to expire on January 1, 1966, but it was amended and passed again in 1965 without a time limit. For a discussion of the Amendment's history and the motives behind it, see Reeves, note 16 *supra.*

25. 243 F. Supp. 957 (S.D.N.Y. 1965). The court, following the court of appeals' holding in *Sabbatino* that the confiscations were invalid, tentatively dismissed Banco Nacional's complaint, deferring final judgment until it could be determined whether the executive branch would indicate if the interests of foreign policy required the application of the act of state doctrine. After the State Department had informed the court that such an indication was not contemplated by the executive, the court rendered final judgment of dismissal. Banco Nacional de Cuba v. Farr, 272 F. Supp. 836 (S.D.N.Y. 1965) *aff'd,* 383 F.2d 166 (2d Cir. 1967).

26. The case was heard by Judge Bryan, who also rendered the district court decisions in the *Sabbatino* litigation.

27. National City Bank v. Republic of China, 348 U.S. 356 (1955); *see* note 9 *supra.*

tions were clearly illegal: not only were they retaliatory[28] and discriminatory,[29] and therefore violative of standards set forth in the *Sabbatino* court of appeals decision, but the confiscations were also without compensation. While the court of appeals and the Supreme Court in *Sabbatino* had not explicitly held that failure to provide compensation for expropriations was by itself a violation of international law, the instant court noted that the Hickenlooper Amendment[30] had expressly adopted the position that "international law . . . requires full compensation for seizures of American-owned property."[31] Although the three standards of retaliation, discrimination and compensation were thought to be representative of international law, the court stated that it would still have been bound to apply them had they been inconsistent with the international rules. Since the Cuban Government seizures were in violation of international law and there had been no executive suggestion that the act of state doctrine be applied, the court concluded that the defendant should be allowed to set-off the value of the seized property against the plaintiff's claim.[32]

The instant decision is consistent with the policy and the mandate of the Hickenlooper Amendment in that it affords some measure of relief to an American enterprise which has lost property under a foreign expropriation decree. The court, however, avoided a logical step which would have further limited sovereign immunity, and it declined to suggest solutions to, or at least crystallize, some jurisprudential problems surrounding its holding on the act of state doctrine. By limiting plaintiff's waiver of immunity to no more than set-off vulnerability, the court failed to take a step taken thus far only in the *Et ve Balik Kurumu* decision.[33] While in that case the counterclaim arose from the same transaction as the plaintiff's claim, whereas the defendant's counterclaim in the instant case involved different subject matter, the permissive-compulsory dichotomy should not be

28. The retaliatory tone of the confiscation decree vitiated the plaintiff's argument that the confiscations were primarily motivated by general public interest. The court cited the decision of the court of appeals for the Second Circuit in the *Sabbatino* case, 307 F. 2d at 866, in which Judge Waterman opined that "[c]onfiscation without compensation when the expropriation is an act of reprisal does not have significant support among disinterested international law commentators from any country."

29. The confiscatory decree was discriminatory in that it was aimed solely at United States' nationals and other banking properties were not seized until a month later. The court cited no authority for the proposition that such discrimination is internationally illegal, but again referred to the court of appeals opinion in *Sabbatino* which does cite international authority in addition to expounding the United States' view. 307 F.2d at 866-68.

30. *See* 22 U.S.C. § 2370(e) (Supp. 1966).

31. 270 F. Supp. at 1008.

32. The defendant's motion for summary judgment was denied since there were triable issues of fact and law as to the amount of defendant's set-off.

33. *See* note 12 *supra*.

determinative. Permitting more than set-off would endanger no interest of foreign policy; rather, it would further effect the policy of the Hickenlooper Amendment. When a foreign sovereign invokes the jurisdiction of a court, it should expect that all claims between it and the party against whom relief is sought will be justly settled.

While the court's act of state holding was consistent with the United States' policy of encouraging private investment in certain underdeveloped countries, it left unanswered questions resulting from the application of United States' law to the acts of a foreign sovereign within its own territory. Three choices of law were available to the court for reaching its decision: Cuban law, the law of the place of the wrong; United States' law, the law of the forum; or international law. Under traditional choice of law rules in private international law cases, the law of the place of the wrong is examined to determine the rights and duties of the parties affected by the wrong.[34] There exists an exception to this rule where the law of the *locus delicti* contradicts an important policy of the forum.[35] In that case the forum rejects the foreign law model in favor of its own policy. However, the act of state doctrine in effect precludes this public policy exception when the cause of action arises from the acts of a foreign sovereign. The Hickenlooper Amendment, on the other hand, vitiates the act of state doctrine's bar, allows forum policy to prevail, and states that the forum policy requires compensation for expropriation. Thus the law of the United States was applied to the acts of the Cuban Government within its own territory. While the model for the rule applied was purportedly international law, the court emphasized that the rule itself was United States' law as set forth in the Hickenlooper Amendment. The forum policy embodied in the Hickenlooper Amendment goes further than American repugnance toward expropriation without compensation; the underlying purpose of the Amendment is to encourage economic growth in South America and other underdeveloped areas by affording some protection to American enterprises investing there.[36]

While it neither alters nor extends the substantive principles set forth in the Second Circuit's *Sabbatino* and *Farr* decisions,[37] the instant case is significant in that it presents the substantive problem in the context of a counterclaim—an affirmative assertion of the Hickenlooper Amendment which had previously been raised only defensively. The case thus clarifies the effect of the Hickenlooper Amendment:

34. RESTATEMENT OF CONFLICT OF LAWS §§ 377-79 (1934).
35. Loucks v. Standard Oil Co., 224 N.Y. 99, 120 N.E. 198 (1918).
36. *See generally* E. MOONEY, FOREIGN SEIZURES (1967).
37. Banco Nacional de Cuba v. Farr, 383 F.2d 166 (2d Cir. 1967); Banco Nacional de Cuba v. Sabbatino, 307 F.2d 845 (2d Cir. 1962).

United States law imposes a duty upon foreign sovereigns to pay for property expropriated within their own territories. Unless the defense of sovereign immunity could be asserted, it would follow that any party whose property was seized without compensation would be able to hold the seizing government or its representative liable for payment. The result might be embarrassing where the foreign sovereign enjoys more amicable relations with the United States than does the Republic of Cuba. Additionally, should the property enter the United States in the hands of a private person to whom the defense of immunity would be unavailable, contravention of the broad policy underlying the Hickenlooper Amendment might result. The United States' interest in the development of emerging nations will not be advanced by those nations' inability to trade in property connected with seizures in compliance with their own law (and, arguably, international law) but subject to attachment in the United States. The simultaneous implementation of a policy protecting American investments abroad and contravention of a policy encouraging the economic development of emerging nations is anomalous, and suggests that both policies might better be served by means other than the Hickenlooper Amendment, such as investment guarantees. The proviso in the Amendment allowing executive resurrection of the act of state doctrine may provide a remedy for some of these problems once they have arisen, but until executive intervention is exercised it provides the interested foreign government no basis for prediction.

The instant case also leaves unresolved the question of title. While the court's implicit finding that title remains in the investor until compensation is paid by the sovereign protects the private American investor in a suit by the confiscating sovereign, complications arise when the investor, the property owner, is sued by a creditor with an interest in the seized property. If title still lies with the defendant property owner, then it follows that the owner is still liable to account for the property, which results in an obvious hardship and a contradiction of the Hickenlooper Amendment's policy of protecting American investment abroad. Perhaps the remedy is executive suggestion that the act of state doctrine be allowed as a defense to the creditor's suit against the property owner. The success of this defense may depend upon whether the creditor's action is prosecuted prior to an adjudication of the confiscating government's act of state claim.

These implications arise from the basic question which must be asked in light of the instant case: to whose law and policy should a sovereign look when acting within its own territory? Classically, the sovereign could rely exclusively on its own law. Now, however, where the state enjoys private investment by American enterprises, in order

to obtain a greater degree of predictability, it must also look to United States' law. This result may be justified in light of this country's narrower foreign policy aims, but the result creates problems relevant to broader policies and does not seem justified in light of the search for an international legal order based on traditional concepts of territoriality.

Products Liability—Lender Held Liable for Gross Defects in Housing Development It Had Financed

Plaintiffs, purchasers of homes in a subdivision,[1] brought an action in tort against a savings and loan association, the major financier of the developer,[2] for damages arising from gross constructional defects in the houses.[3] The gravamen of the plaintiffs' claim was that, by furnishing a substantial portion of the funds for the project, the defendant had assumed a duty to inspect to protect prospective purchasers.[4] The defendant argued that the loan transactions were insufficient to impose a duty upon the loan association to inspect. The trial court granted defendant's motion for a nonsuit at the close of plaintiffs' proof. On appeal to the California District Court of Appeal, *held*, reversed. Where a lender furnishes the major portion of financing for a housing development, it assumes a duty to the potential buyers, at least to the extent of protecting them from gross

1. Plaintiffs bought homes built from a set of master plans and apparently they exercised control over neither the specifications nor the building. The buyers sued the developer, Conejo Development Co., the primary lender, Great Western Savings and Loan Association, and others for recision and restitution or alternatively for damages for construction defects. At the trial, the court first tried solely the issues relating to liability of Great Western [hereinafter referred to as defendant].

2. The financial arrangements were quite complex and never fully disclosed. Defendant lent a substantial sum and arranged the financing so as to make the deal possible. At one point, it even held title to the land. It also had first refusal as to the trust deed financing for all of the houses. The developer's capital and experience were known to be limited.

3. The land contained a type of soil which greatly expanded when wet and damaged normal foundations. The houses had been built without any special foundations and sold for about $15,000 each. The action of the soil damaged the houses, and the court estimated the damages at about $6,000 per house. Though the developer either knew or at least received information so that he should have suspected that the land had expansive soil, there is no evidence that defendant ever knew or was informed. However, this type of soil is not unusual in the area and was prevalent in the valley.

4. The court noted that one of the developers had been in the clothing business until 1955 and his experience as a developer was largely confined to selling tracts and that the other developer had built about fifty houses, including a few with the special foundations necessary to withstand expansive soil.

structural defects. *Connor v. Conejo Land Development Co.*, 61 Cal. Rptr. 333 (Ct. App. 1967).

Although the specific issue of a lender's liability for failure to inspect projects has not previously been determined,[5] the broadening concepts of products liability and their extension to defendants previously insulated by rules of privity has been a widely recognized trend. A recent development in this trend is evidenced by decisions indicating that inspectors may be held liable for injuries caused by defects in the inspected products. In *Buszta v. Souther*,[6] where a service station operator negligently inspected an automobile, certifying it to be in good condition, the court in awarding damages to the injured driver disregarded privity and looked to the obvious and unreasonable risk of harm if due care is not exercised. Similarly, in *Hempstead v. General Fire Extinguisher Corp.*,[7] the court held that liability could be imposed on Underwriters Laboratory where an exploding fire extinguisher did not conform to the warranty of the Underwriters' inspection tag on the label. Although these decisions rested on the defendant's duty to inspect, in each case the defendant was negligent in an undertaking upon which the plaintiff might foreseeably rely. However, there is little authority for the imposition of an affirmative duty to inspect.[8] Traditionally, affirmative duties in tort law were limited; but the trend is toward liberalization. Thus in *Schwartz v. Helms Bakery Ltd.*,[9] the court circumvented the absence of a duty to act by stretching the exception that one who undertakes an affirmative course of conduct undertakes a concomitant duty to exercise due care in its execution. More broadly, progress in products liability cases in most states has been characterized by increasing liberality as to the theory of recovery and as to remedy.[10] Thus in

5. There have been several cases proceeding on a restitutionary theory in which the defendant knew of his debtor's intended fraud. *See, e.g.*, Stewart v. Wright, 147 F. 321 (8th Cir. 1906) (bank financed bogus race); Jorgensen v. Albertson, 129 Wash. 686, 225 P. 639 (1924) (defendant knew, or should have known, and made false representations which were relied upon).

6. 232 A.2d 396 (R.I. 1967).

7. 269 F. Supp. 109 (D. Del. 1967).

8. The leading article is Bohlen, *The Basis of Affirmative Obligations in the Law of Tort*, 44 AM. L. REV. (n.s.) 209 (1905) (reprinted in BOHLEN, STUDIES IN THE LAW OF TORTS (1926)). A later treatment is McNiece & Thornton, *Affirmative Duties in Tort*, 58 YALE L.J. 1272 (1949). The latter article restates Bohlen's observation that the duty is based on a "benefit principle" analogous to the doctrine of consideration in contracts, a principle that there is a duty when the defendant was to receive a potential benefit.

9. 430 P.2d 68, 60 Cal. Rptr. 510 (Sup. Ct. 1967) (in bank). The opinion contains a good general discussion of the court's view as to when a duty is assumed to protect against foreseeable harm.

10. For an introduction and historical development of the subject, see Prosser's classic article, *The Assault Upon the Citadel (Strict Liability to the Consumer)*, 69 YALE L.J. 1099 (1960), or his more recent article, *The Fall of the Citadel (Strict*

Biakanja v. Irving,[11] establishing liability without privity even though the risk involved was restricted to property damage, the California court held the question to be a matter of policy involving "the balancing of various factors, among which are the extent to which the transaction was intended to affect the plaintiff, the foreseeability of harm to him, the degree of certainty that the plaintiff suffered injury, the closeness of the connection between the defendant's conduct and the injury suffered, the moral blame attached to the defendant's conduct and the policy of preventing future harm."[12] Thus a court in California confronted with a novel negligence action would be free to consider its merits in relation to these standards regardless of a lack of privity.[13] In this regard, builders and contractors have found a lack of privity no defense.[14] In *Sabella v. Wisler*,[15] for example, an experienced builder-vendor who constructed a house on an improperly filled lot was held liable to buyers of the house for damages resulting when the house began to settle. The court held that it was immaterial that defendant had not built the house especially for the plaintiffs, since they were "members of the class of prospective home buyers for which Wisler admittedly built

Liability to the Consumer), 50 MINN. L. REV. 791 (1966). For a treatment of historical as well as recent developments in California, see Lascher, *Strict Liability in Tort for Defective Products: The Road To and Past Vandermark*, 38 S. CAL. L. REV. 30 (1965).

11. 49 Cal. 2d 647, 320 P.2d 16 (1958). The court held a notary public who had negligently prepared a will liable to one who would have been a beneficiary had it been valid. The case contains a good discussion of the development and demise of privity in California.

12. 49 Cal. 2d at 650, 320 P.2d at 19. The language was adopted with only minor changes in wording in Stewart v. Cox, 55 Cal. 2d 857, 863, 362 P.2d 345, 348, 13 Cal. Rptr. 521, 524 (1961), and in Sabella v. Wisler, 59 Cal. 2d 21, 28, 377 P.2d 889, 893 (1963).

13. There have been other similarly liberal statements in recent California decisions as to when a duty relationship may be found. *See, e.g.*, the broad statement, cited in the instant case, 61 Cal. Rptr. at 344, from Raymond v. Paradise Unified School Dist., 218 Cal. App. 2d 1, 8, 31 Cal. Rptr. 847, 851 (1963); and the statement in Merrill v. Buck, also cited in the instant case, 58 Cal. 2d 552, 561-62, 375 P.2d 304, 310, 25 Cal. Rptr. 456, 462 (1962), that a duty of ordinary care not to injure another "may arise out of a voluntarily assumed relationship if public policy dictates the existence of such a duty." *See also* as an indication of the same trend, a recent case imposing a non-delegable duty on manufacturers to supply a product free from dangerous defects. Vandermark v. Ford Motor Co., 61 Cal. 2d 256, 391 P.2d 268, 37 Cal. Rptr. 896 (1964).

14. *See, e.g.*, Stewart v. Cox, 55 Cal. 2d 857, 362 P.2d 345, 13 Cal. Rptr. 521 (1961), where the state supreme court, in bank, held an independent contractor who had performed his portion of the work on the swimming pool in a manner which allowed the water to leak, liable to the owner for damages to the pool and for the undermining of the house and yard by the leaking water. The doctrines of warranty, products liability, and strict liability have been slow in penetrating traditional real property concepts. *See, e.g.*, Bearman, *Caveat Emptor in Sales of Realty—Recent Assaults upon the Rule*, 14 VAND. L. REV. 541 (1961).

15. 59 Cal. 2d 21, 377 P.2d 889, 27 Cal. Rptr. 689 (1963).

the dwelling."[16] The opinion imposed an affirmative duty upon the builder to use reasonable care to assure the land was suitable.[17] Although the California courts have gone far to impose an affirmative duty to foreseeable users, regardless of privity, upon anyone actually engaging in building, manufacturing, or selling, the instant case is the first to consider the question of the duty owed by one whose only connection with the product was that of a secured investor.

In the instant case, the court stated that although defendant was not a direct participant in the construction, it was not insulated from responsibility to purchasers since privity of contract is not essential to establish a duty of ordinary care. Noticing that this duty may arise from a voluntarily assumed relationship if public policy so dictates,[18] the court determined that public policy required low-income purchasers to be protected from substantial defects which a reasonable inspection would not disclose. The court stated that lenders, like manufacturers, have the power to launch potentially hazardous products into the market and, like manufacturers, have the power to control to some extent the quality of the product.[19] To effectuate the public policy purposes applicable to developers and contractors in such situations, the court held that liability would be imposed upon a lender who failed to use his position of power to assure minimal standards. However, the opinion emphasized that the holding only applied to gross defects.[20]

16. 59 Cal. 2d at 28, 377 P.2d at 893, 27 Cal. Rptr. at 693.

17. The lot had been a quarry and when filled in gave no indication that it had ever been anything but level ground. However, the court was not concerned that Wisler did not know the lot was filled and that it was a level lot at the base of a rock cliff. The court also mentioned that the builder should have become suspicious of the earth when digging a hole for the foundation but this notice did not appear necessary for its holding.

18. Merrill v. Buck, 58 Cal. 2d 552, 561-62, 375 P.2d 304, 310, 25 Cal. Rptr. 456, 462 (1962). In addition, the court quoted and cited a number of statements recognizing broad liability; *e.g.*, Sabella v. Wisler, 59 Cal. 2d 21, 28, 377 P.2d 889, 893, 27 Cal. Rptr. 689, 693 (1963); Stewart v. Cox, 55 Cal. 2d 857, 863, 362 P.2d 345, 348, 13 Cal. Rptr. 521, 524 (1961); Biakanja v. Irving, 49 Cal. 2d 647, 650, 320 P.2d 16, 19 (1958). The court also relied on a recent New Jersey case, Schipper v. Levitt & Sons, Inc., 44 N.J. 70, 207 A.2d 314 (1965), which applied the analogy of manufacturers and developers and also relied on general policy arguments to demonstrate that the courts should be liberal to hold the developer and protect the buyer.

19. The court employed a law review article, Lefcoe & Dobson, *Savings Associations as Land Developers*, 75 YALE L.J. 1271 (1966), to show that in the low-priced tract subdivisions of small developers a savings and loan association is usually the principal backer, the most solvent and reputable party, and the most experienced participant.

20. Possible breaches of duty listed by the court in this case included: negligent appraisal and representation of the value of the homes, failure to ascertain and compensate for soil conditions, approval of packaged plans and specifications without sufficient examination, engaging in total financing of an insubstantial and inexperienced developer on a tract of major proportions in a new area, or a failure to adequately inspect the work in progress in order to discover defects. 61 Cal. Rptr. at 344.

Under the facts presented by the court, the decision is undeniably appealing. However, the establishment of this significant extension as a general principle of tort law seems unjustified. The conceptual and practical problems presented by the holding stem primarily from the questionable analogy drawn by the court between manufacturers and contractors and financial institutions. While the manufacturer and contractor are both builders whose function is integrally connected with making the product, the financial institution's business is making profitable loans and its function often does not involve more than a minimum of building expertise or inspection. Sound management requires it to have men competent to assess land values and so protect its investment, but these men do not necessarily have the competence to oversee a builder. While the technical expertise associated with the production of goods or erection of buildings is a necessary corollary to the business of the manufacturer or builder, such expertise is tangential at best to the business of a lending institution. Even limited to substantial defects, the court's rule would be impractical. The court in its considerations of public policy gave insufficient consideration to the potential burdens placed upon lenders in all fields by its decision. The court failed to give proper weight to the public policy in favor of keeping financing costs, including building costs, down. It is submitted that ambiguous decisions imposing an open-ended duty prevent the predictability of result necessary for sound business planning. And finally, if there is a substantial need for regulation of developers, it is the function of the legislature to provide it. The duty to protect purchasers against those from whom they purchase would be better placed upon a commission or agency than upon a lender with a deep pocket whose incentive to protect extends only to the limits of its liability.

Taxation–Constructive Ownership Rules Automatically Applied to Section 302(b)(1) Dividend Equivalency Test

From 1960 through 1963 petitioner reported as long-term capital gain payments which she received pursuant to a 1960 redemption agreement. Under the contract she and her brother agreed with her son, the sole remaining shareholder, to redeem all of their common stock in a closely-held family corporation in exchange for a fixed sum, payable in annual installments.[1] The Commissioner of Internal

1. From 1948 to 1957, of the 1300 outstanding shares, petitioner owned 650; her brother 649; and her son 1. In 1957 her son desired to assume a greater share of the

Revenue assessed a deficiency after applying the family attribution rules of section 318(a)[2] so that subsequent to the redemption petitioner retained constructive ownership of the corporation and therefore the payments were essentially equivalent to dividends under section 302(b)(1)[3] and taxable at ordinary income rates. Petitioner contended that the redemption distributions were not "essentially equivalent" since they resulted in a meaningful change in her rights of ownership and control regardless of the constructive ownership rules and, further, that the distribution was made pursuant to a bona fide business purpose sufficient to overcome any inference of tax avoidance. The Tax Court sustained the Commissioner's assessment of deficiencies,[4] and on appeal to the United States Court of Appeals for the Second Circuit, *held*, affirmed. In the absence of significant mitigating circumstances to the contrary, section 318(a) constructive ownership rules apply automatically, regardless of business purpose, in determining a change in a shareholder's proportionate ownership for purposes of the dividend equivalency test of section 302(b)(1). *Levin v. Commissioner*, 385 F.2d 521 (2d Cir. 1967).

After the United States Supreme Court determined in *Eisner v. Macomber*[5] that dividends paid in stock were not income, a tax avoidance device developed whereby stock distributed as a nontaxable dividend was redeemed by the corporation, which enabled the shareholder to treat this redemption[6] as a sale of stock, paying only a capital gains tax on the profit realized, and thus totally escaping the ordinary income tax payments due on cash dividends.[7] Congress provided in 1921 that if such distributions and redemptions were "essentially equivalent to the distribution of a taxable dividend, the amount received . . . [would] be treated as a taxable dividend. . . ."[8] This test, as embodied in section 115(g) of the 1939 Internal Revenue Code, was applied to all stock redemptions to distinguish between

business and, therefore, all certificates were canceled and new shares issued as follows: petitioner 485; her brother 484; and her son 331. Then in 1960 the three shareholders resolved that the corporation would redeem all of the stock owned by petitioner and her brother so that petitioner's son could own the business outright, while his mother and uncle could retire with a continued means of support. Subsequent to the redemption, petitioner and her brother (until his death in 1962) were retained as directors of the corporation for reasons of "respect and sentiment," but petitioner's son conducted the business with "a greater freedom of action." Beatrice Levin, 47 T.C. 258, 259-60 (1966).

2. INT. REV. CODE of 1954, § 318(a).
3. *Id.*, § 302(b)(1).
4. Beatrice Levin, 47 T.C. 258 (1966).
5. 252 U.S. 189 (1920).
6. *See* INT. REV. CODE of 1954, § 317(b).
7. Holden & Mickey, *Distributions Essentially Equivalent to a Dividend—Understanding The Equation*, 43 N.C.L. REV. 32, 33 (1964).
8. Revenue Act of 1921, ch. 136, § 201(d), 42 Stat. 228 (1921).

"sales or exchanges" of corporate interests and mere dividend distributions. The meaning of the test's vague language was, however, left to judicial interpretation, and the courts developed various evidentiary criteria[9] considered to be relevant to dividend equivalency. Since the objective of the statutory test was the detection and elimination of tax avoidance schemes, the most important criterion, although not always controlling, was the presence or absence of a bona fide business purpose for the redemption.[10] Then in a 1945 decision, *Commissioner v. Estate of Bedford*,[11] the Supreme Court adopted a "net effect" approach which utilized the economic realities of a redemption as the controlling criterion and foreclosed inquiry into subjective motives.[12] Eventually, however, two lines of reasoning developed which can be categorized generally as the "strict" and "flexible" net effect tests. The "strict" test, adhering to the emphasis on objectivity of the Supreme Court in *Bedford*, involved a comparison of the economic effects of the actual redemption distribution with hypothetical economic effects had there been a dividend distribution, culminating in a determination of dividend equivalency if the comparative results were essentially the same.[13] While also making a comparative review of the economic realities of the distribution, the "flexible" test enabled the court to admit evidence of business

9. Some questions asked by the courts were: (1) was there a bona fide corporate business purpose; (2) was the action initiated by the corporation or by the shareholder; (3) did the corporation adopt any plan or policy of contraction; (4) did the corporation continue to operate at a profit; (5) did the transaction result in any substantial change in the proportionate ownership of the stock held by the shareholders; (6) what were the amounts, frequency and significant dividends paid in the past; (7) was there a sufficient accumulation of earned surplus to cover the distribution or was it partly out of capital? Flanagan v. Helvering, 116 F.2d 937, 939 (D.C. Cir. 1940); Genevra Herman, 32 T.C. 479 (1959).

10. Some of the factors and circumstances generally considered to be valid business purposes for the redemption under § 115(g) of the 1939 Code were: (1) enabling the business to operate more efficiently as a sole proprietorship or as a partnership; (2) the conduct of part of its business under separate corporate form; (3) enhancement of its credit rating by calling in stock to cancel stockholder indebtedness; (4) resale of stock to junior executives; (5) provision of a profitable investment for an employees' association; (6) adjustment for a legitimate shrinkage of the business following a fire causing a permanent reduction in productive capacity; (7) elimination of unprofitable departments; (8) contemplation of ultimate liquidation. B. BITTKER, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 211 (1959).

11. Commissioner v. Estate of Bedford, 325 U.S. 283 (1945) (effect, not form, is controlling).

12. The basic "net effect" test was actually adopted in Flanagan v. Helvering, 116 F.2d 937 (D.C. Cir. 1940) ("net effect" rather than motives and plans is the essential criterion of "equivalency").

13. In making the comparison, factors to be considered were whether the same shareholders would have received the identical payments had the redemption been a dividend, and whether the redemption altered the shareholders' respective rights to future earnings and control over the corporation. *See generally* Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962).

purpose so that the inferences of the objective comparison might be overcome by the demonstrable existence of a legitimate business motivation and thus prevent injustice to the shareholder.[14] In its draft of section 302 of the 1954 Code[15] the House Ways and Means Committee sought to promote certainty and predictability in the field of dividend equivalency by providing only automatic formulae for use in redemption situations.[16] No generally applicable "essentially equivalent" provision similar to section 115(g) was included, but the Senate Finance Committee inserted such a provision by adding section 302(b)(1), stating that the House bill "appeared unnecessarily restrictive."[17] The independency of the broad equivalency test was further ensured by section 302(b)(5), which states that failure to comply with the automatic formulae sections, 302(b)(2)-(4), does not preclude inquiry into dividend equivalency under section 302(b)(1). However, controversy still exists as to the general interpretation and intended scope of section 302(b)(1). If "existing law"[18] and the words following in the Senate Report are given a literal construction, then it is arguable that the section was added to incorporate all of the pre-1954 judicial interpretation of the phrase "essentially equivalent to a dividend." But if the section was included only to prevent possible injustice to shareholders by application of the strict House bill in several isolated circumstances, such as sudden corporate redemptions of minority preferred stock holdings,[19] then it is "not easy to give section 302(b)(1) an expansive construction"[20] and it therefore would assume a limited role in keeping with the objective thrust of the section of which it is a part.

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14. *See* Keefe v. Cote, 213 F.2d 651 (1st Cir. 1954) (essentially pro rata redemption was part of legitimate corporate purpose and therefore not dividend).

15. H.R. REP. No. 1337, 83d Cong., 2d Sess. (1954).

16. These formulae are represented by INT. REV. CODE of 1954, §§ 302(b)(2)-(4).

17. "While the House bill sets forth definite conditions under which stock may be redeemed at capital gains rates, these rules appeared unnecessarily restrictive, particularly in the case of redemption of preferred stock which might be called by a corporation without the shareholder having any control over when the redemption may take place. Accordingly, your Committee follows existing law by reinserting the general language indicating that a redemption shall be treated as a distribution in part or full payment in exchange for stock if the redemption is not essentially equivalent to a dividend." S. REP. No. 1622, 83d Cong., 2d Sess. 44-45 (1954).

18. "In general, under this subsection your Committee intends to incorporate into the bill existing law as to whether or not a reduction is essentially equivalent to a dividend under section 115(g)(1) of the 1939 Code, and in addition to provide three definite standards in order to provide certainty in specific instances. . . . The test intended to be incorporated in the interpretation of paragraph (1) section 302(b)(1) is in general that currently employed under section 115(g) of the 1939 Code." *Id.* at 45.

19. S. REP. No. 1622, *supra* note 17.

20. B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS 291 (2d ed. 1966).

The weight of case law under section 302(b)(1) reveals that the courts have generally regarded the section as intended to incorporate existing law including the numerous variations of the "net effect" test.[21] Nevertheless, pre-1954 confusion still exists with respect to the relative importance of "business purpose" among other more objective criteria indicating economic effect. Most courts have adopted the flexible "net effect" test and have reviewed evidence purporting to show a legitimate business purpose,[22] but they have generally not viewed it as controlling, unless the business motive is substantial.[23] The minority position has adhered to the strict net effect objective approach and has generally disregarded the subjective business motive.[24]

Regardless of which variation of the "net effect" test is chosen, a court must still determine whether a redemption has effected a meaningful change in a shareholder's position relative to the corporation and other shareholders. Thus, another significant change in the 1954 Code is relevant to the dividend equivalency determination. The House Ways and Means Committee included in its version of the bill certain constructive ownership rules, embodied in section 318(a) and made applicable to section 302(b) by section 302(c). However, the extent to which the attribution rules are applicable to section 302(b)(1) has been questioned by some authorities,[25] since the Senate addition of the section 302(b)(1) general equivalency test made no reference to the constructive ownership rules. This problem becomes especially significant when the stock in question is held by family members in a closely-held corporation and none of the automatic formulae of sections 302(b)(2)-(4) apply. Most courts have automatically applied the family attribution (constructive ownership) rules,[26] regardless of legislative history, and this has resulted in striking variations from pre-1954 law, since the rules did not then

21. *See* Kerr v. Commissioner, 326 F.2d 225 (9th Cir. 1964) (applied flexible "net effect" test to find dividend equivalency); Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962) (discusses both "flexible" and "strict" and finds dividend equivalency).

22. *See* Kerr v. Commissioner, 326 F.2d 255 (9th Cir. 1964).

23. *See id.*; Ballenger v. United States, 301 F.2d 192 (4th Cir. 1962); Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962) (recognized taxpayer had proved valid business purpose but held not sufficient to overcome pro rata distribution).

24. *See, e.g.*, McGinty v. Commissioner, 325 F.2d 820 (2d Cir. 1963) (applied strict "net effect" test to find dividend equivalency).

25. *See, e.g.*, Cohen, *Redemptions of Stock Under the Internal Revenue Code of 1954*, 103 U. PA. L. REV. 739, 758-59 (1955). The Treasury Regulations initially made the application of the attribution rules to § 302(b)(1) mandatory, but they now provide only that the rules are "one of the facts to be considered . . . ." Treas. Reg. § 1.302-2(b) (1955).

26. *See* Bradbury v. Commissioner, 298 F.2d 111 (1st Cir. 1962) (applied attribution rules to find shareholder's position did not change significantly); Thomas G. Lewis, 35 T.C. 71 (1960) (applied attribution rules, recognizing it as "new dimension").

exist statutorily.[27] The Tax Court has, nevertheless, shown an inclination to apply the attribution rules only when the facts of the case reveal a sufficient community of interest to dictate their application.[28] This approach has likewise been endorsed by the Fourth Circuit and some commentators.[29]

In interpreting section 302(b)(1) the instant court first synthesized the various dividend equivalency tests of section 115(g) and recognized that its past reliance on economic effects resulting from changes in a shareholder's basic rights of ownership was a much more objective net effect test than those adopted by other courts. Reviewing the legislative history of 302(b)(1), the court concluded that the section should not be given an "expansive" role, but should be applied in a manner consistent with its "objective" statutory context. The court then reasoned that the section 318(a) constructive ownership rules likewise represented an objective approach and concluded that section 302(c)(1) makes the section 318(a) rules applicable to section 302(b) stock ownership situations and, therefore, subsequent to the redemption the petitioner must be deemed the owner of her son's shares.[30] The court rejected petitioner's argument that the "bona fides" of the redemption should be considered to reflect the absence of a tax avoidance motive and therefore mitigate the family attribution rules. While the court admitted that a proper case might indeed require such mitigation, it noted that petitioner had shown no valid reason here for refraining from an automatic application of the attribution rules.

Although decisional interpretation of section 302(b)(1) contains few settled principles, there are certain apparent trends which provide an adequate starting point for an analysis of the instant court's conclusions. In every dividend equivalency determination under section 302(b)(1) it is first necessary to consider what changes, if any, occurred in the shareholder's basic interests in the corporation, since a distribution of an ordinary dividend does not disturb such

27. *Id.*

28. *See* Perry S. Lewis, 47 T.C. 129 (1966) (ignored attribution rules and found no dividend equivalency); Estate of Arthur H. Squier, 35 T.C. 950 (1961) (applied attribution rules but found no dividend equivalency, since sufficient family estrangement present to reduce community of interest). One district court has recently applied the attribution rules but found an overriding business purpose. Davis v. United States, 274 F. Supp. 466 (M.D. Tenn. 1967).

29. *See* Ballenger v. United States, 301 F.2d 192, 199 (4th Cir. 1962); B. BITTKER & J. EUSTICE, *supra* note 20, at 292; Bittker, *The Taxation of Stock Redemptions and Partial Liquidations*, 44 CORNELL L.Q. 299 (1959).

30. 385 F.2d at 526. Before the redemption petitioner owned 484 shares and constructively owned her son's 331 shares, or about 63% of the outstanding shares. Thus, after the redemption her son owned all of the shares, but under the court's application of § 318(a) petitioner still constructively owned all of her son's shares and she therefore became the constructive owner of 100% of the stock.

interests. In this regard, the instant court's emphasis on objective changes in basic rights of ownership is consistent with the rationale of the flexible "net effect" test. However, the flexible "net effect" jurisdictions, which comprise a preponderant majority, go one step further and permit a showing of a substantial business purpose as an additional factor for consideration. It can be argued that dividend equivalence is a status and that the particular subjective motive is irrelevant. Further, a tax avoidance motive is not always present in the context of a final determination of divided equivalency, and, in fact, a legitimate motive might be present. Certainly, a tax advisor can never rely with certainty upon whether a particular legitimate business purpose will qualify a redemption for capital gains treatment. Nevertheless, the legislative history of the 1954 Code reveals that section 302(b)(1) was reinserted into the area of dividend equivalency as a subjective influence. In view of this, the instant court's conclusion that the section was intended to provide a restricted, objective function is erroneous. It is clear that the House version of section 302 was written with predictability as its object, and consequently it was considerably more severe than section 115(g). But the Senate's addition of the section 302(b)(1) general equivalency test, under the stated purpose of maintaining existing law, had a definite liberalizing effect upon the thrust of section 302. Therefore it is strongly arguable that the Code draftsmen intended that business purpose, being a significant factor in existing law, should be considered as a factor in a section 302(b)(1) equivalency determination. Furthermore, since it was apparently the function of section 302(b)(1) to provide a vehicle for factual inquiry, the instant court's conclusions with respect to application of the section 318(a) attribution rules are subject to question. Existing law in 1954 did not include statutory constructive ownership rules, and certainly legislative history does not conclusively indicate that the rules should be applied to section 302(b)(1). Further, the function of the attribution rules is to reflect a presumed community of interest. However, since such a presumption may well be at variance with actual facts, there is no good reason to deny capital gains treatment on the basis of a conclusive presumption. The instant court stated that strict application of the attribution rules may be inappropriate[31] in certain cases, but its earlier language which emphasized "certainty" and "precision" in applying the rules reflects a reluctance to consider the "bona fides" of a change in ownership if the attribution rules dictate a finding of dividend equivalency. In effect, an automatic application of the rules forecloses further factual inquiry which is contrary to the basic policy of section

31. *Id.* at 527.

302(b)(1). A more proper approach to the constructive ownership rules in respect to this section would seem to require their application only when prior factual inquiry reveals a sufficient community of interest.

Taxation–IRS Rules Organization Which Discriminates on Basis of Race Not Charitable

The Internal Revenue Service was asked for its opinion as to whether a non-profit corporation which provides free recreational facilities to all residents of the community except members of the Negro race is exempt from the federal income tax as a charitable organization described in section 501(c)(3) of the Internal Revenue Code, and whether contributions and transfers to or for the use of such an organization are deductible under sections 170, 2055, 2106, and 2522 of the Code. The Internal Revenue Service, *ruled*, no. A non-profit organization which operates a facility established for the benefit of all the members of the community is not exempt from the federal income tax as a charitable organization, if the use of the facility is restricted to less than the entire community on the basis of race, and contributions and transfers to or for the use of such an organization are not deductible. *Rev. Rul. 67-325*, 1967 INT. REV. BULL. No. 40, at 7.

Section 170 of the Internal Revenue Code allows an income tax deduction from the taxpayer's gross income for "charitable contributions" to a wide range of organizations, including those "organized and operated exclusively for . . . charitable . . . purposes . . . ."[1] To further encourage charitable pursuits, section 501 of the Code grants tax-exempt status to certain organizations, including those organized for exclusively charitable purposes.[2] The Regulations define "charitable" for income tax purposes in "its generally accepted legal sense,"[3] as determined by general principles of trust law. Under trust doctrine, to be considered charitable, a trust must confer a public benefit.[4] Certain purposes have been presumed to be sufficiently for the public benefit despite the fact that the class of beneficiaries is limited. As

1. INT. REV. CODE of 1954, § 170(c)(2)(B).

2. INT. REV. CODE of 1954, § 501(c)(3), grants an exemption from income tax to: "Corporations, and any community chest, fund or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes. . . ." Similar deductions from federal estate and gift taxes are allowed in sections 2055 (transfers for public, charitable, and religious uses), 2106 (taxable estate), and 2522 (deduction for charitable and similar gifts).

3. Treas. Reg. § 1.501(c)(3)-1(d)(2) (1961).

4. *See* 4 A. SCOTT, THE LAW OF TRUSTS, §§ 375-375.2 (2d ed. 1956).

long as the class is large enough so that the attainment of the trust purposes is of sufficient benefit to the community, the trust will be upheld as charitable. Such purposes include trusts to advance education, promote health, alleviate poverty and further religion.[5] On the other hand, certain purposes may or may not be charitable depending upon the size of the class of beneficiaries. For example, a social club may be charitable if the class is large, but when the class becomes so narrow that the community as a whole has no interest in the organization's activities, it ceases to be charitable. Therefore, where the purpose is not presumed to be of a public benefit, the class of beneficiaries must be wider than that required for trusts to relieve poverty, promote education, or protect health.[6] However, it is not required that a trust include all the members of the community in the class of beneficiaries.[7] An organization to provide recreational facilities falls within this second category and will be deemed charitable only if the class is wide enough to serve a public purpose. Prior to 1959, the Internal Revenue Service did not allow a deduction under section 170 for contributions to organizations to establish community recreational facilities. But in 1959, the Service acquiesced in a 1953 Tax Court decision which allowed such a deduction on the ground that the contribution was to a non-profit organization operated exclusively for the promotion of social welfare.[8] In that case, the court specifically noted that the contemplated recreational facilities were not restricted in any sense, but were for the use of every member of the community. Although few prior cases have dealt with the validity of tax exemptions and deductions for contributions to racially selective organizations, such exemptions and deductions appear to have been freely granted.[9]

5. RESTATEMENT (SECOND) OF TRUSTS §§ 369-73 (1959): § 369 (relief of poverty), § 370 (advancement of education), § 371 (advancement of religion), § 372 (promotion of health), § 373 (governmental or municipal purposes).

6. Professor Scott notes that "a trust to promote the happiness or well-being of members of the community is charitable, although it is not a trust to relieve poverty, advance education, promote religion, or protect health. In such a case, however, the trust must be for the benefit of the members of the community generally and not merely for the benefit of a class of persons." 4 SCOTT, *supra* note 4, at § 375.2. *See* RESTATEMENT (SECOND) OF TRUSTS §368(f) (1959).

7. "[A] trust to promote the happiness or well-being of members of the community . . . need not directly benefit all the members of the community" but "a trust unconnected with the relief of poverty or the advancement of education or religion or health in order to be charitable must be for the benefit of a larger class than need be benefitted if the trust is counected with such purposes." 4 A. SCOTT, *supra* note 4, at § 375.2.

8. Peters v. Commissioner, 21 T.C. 55 (1953), *non acq.*, 1955-1 CUM. BULL. 8, *acquiesced in*, 1959-2 CUM. BULL. 6.

9. In Dorsey v. Stuyvesant Town Corp., 299 N.Y. 512, 87 N.E.2d 541 (1949), *cert. denied*, 339 U.S. 981 (1950), a taxpayer's suit to enjoin the granting of a state tax exemption to a corporation which leased apartments on a discriminatory basis

The Internal Revenue Service, in the instant ruling, noted that the Internal Revenue Code contains no "specialized tax concept" of charitable purposes, but favors only those purposes which are recognized as charitable by trust law. The Service considered organizations to be charitable if they were: (1) non-profit, (2) served a generally recognized public purpose, and (3) were for the members of the general public. In regard to the third requirement, the Service posited that the class had to include the *entire* community to be considered charitable. Since part of the community was excluded on the basis of race, the class was not composed of the entire community, and therefore, the recreational facilities were not entitled to tax-exemption as a charitable organization under section 501. Furthermore, contributions to the discriminatory non-profit corporation were non-dedeductible for income tax purposes under section 170, nor were transfers to it deductible for estate or gift tax purposes under sections 2055, 2106, and 2522.

In the instant ruling, the Internal Revenue Service dealt only with the tax-exempt status of organizations of general benefit to the community, which require a wider class of beneficiaries to be considered charitable.[10] The ruling, then, is inapplicable to many of the most invidious examples of racial discrimination. Where an organization is performing a function considered intrinsically for the public benefit, the class of beneficiaries may be narrow without the organization being deemed non-charitable. Thus, the ruling does not encompass racially restrictive organizations furthering education, promoting health, or alleviating poverty, and they will retain their current tax-exempt status. There is very little reason not to extend the instant ruling to encompass all charitable organizations. The Regulations require all organizations qualifying under section 501 to

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was dismissed for lack of standing. The decision was unanimous. In a companion case, the court, by a 4-3 vote, held that a tax exemption was not sufficient to support state action. The court stated: "Tax exemption and the power of eminent domain are freely given to many organizations which necessarily limit their benefits to a restricted group. It has not been held that that the recipients are subject to the restraints of the Fourteenth Amendment." *Id.* at 535, 87 N.E.2d at 551. *But see* Kerr v. Enoch Pratt Free Library, 149 F.2d 212 (4th Cir.), *cert. denied,* 326 U.S. 721 (1945) (direct state financial support of public library constituted state action forbidden by fourteenth amendment). It can be argued that since tax exemptions constitute financial support from the state which must be offset by higher taxes on non-exempt taxpayers, it is inconsistent to allow indirectly that which is prohibited directly. *See* Clark, *Charitable Trusts, the Fourteenth Amendment and the Will of Stephen Girard,* 66 YALE L.J. 979 (1957), especially note 96 and accompanying text.

10. The Service expanded the requirements for a "general benefit, wide class of beneficiaries" trust by requiring the class to include the entire community. Professor Scott did not feel that the entire community need be included, but only felt a class wider than that needed for a trust performing a purpose considered intrinsically charitable was required.

serve a public purpose.[11] Furthermore, under trust law, a trust performing activities which are against public policy is non-charitable.[12] To continue to grant tax-exempt status to racially segregated organizations presently considered charitable would contravene a prevailing public policy against racial segregation.[13] While segregated private schools admittedly perform a public service by educating some members of the community, they may do psychological harm to a sizable portion of the public.[14] Racially discriminatory charitable organizations operated for purposes to which this ruling does not presently apply are sufficiently against public policy to lose their tax exemptions as charitable organizations. Finally, to continue to grant tax exemptions and to allow tax deductions may violate the Civil Rights Act of 1964,[15] which prohibits racial discrimination "under any program or activity receiving [f]ederal financial assistance."[16] The legislative

11. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (1961). *See also* H.R. REP. No. 1860, 75th Cong., 3d Sess. 19 (1938), cited in UNITED STATES COMM'N ON CIVIL RIGHTS, SOUTHERN SCHOOL DESEGREGATION 237 (1967): "The Government is compensated for the loss of revenue by its relief from financial burdens which would otherwise have to be met by appropriations from public funds, and by benefits resulting from the general welfare."

12. RESTATEMENT (SECOND) OF TRUSTS § 377, comment (c) (1959). *See also* UNITED STATES COMM'N ON CIVIL RIGHTS, *supra* note 11, at 240-41. In fact, tax exempt status for segregated organizations may be illegal as violative of the fourteenth amendment. *Id.* at 245-52.

13. *See* RESTATEMENT (SECOND) OF TRUSTS § 368, comment (b) (1959): "A purpose is charitable if its accomplishment is of such social interest to the community as to justify permitting the property to be devoted to the purpose in perpetuity. . . . There is no fixed standard to determine what purposes are of such interest to the community; the interests of the community vary with time and place." *See also* Power, *The Racially Discriminatory Charitable Trust: A Suggested Treatment*, 9 ST. LOUIS L.J. 478, 481-82 (1965).

14. "Classification by race is altogether different in psychological origin and effect from other methods of classifying beneficiaries. It is designed to hurt not to benefit, and sociologists tell us that this is its effect. The malevolence of racial selection is the antithesis of charity, and therein might be found the basis for a legal distinction." Clark, *supra* note 9, at 1001. *See generally* A. KARDINER & L. OVESEY, THE MARK OF OPPRESSION (1951).

15. 42 U.S.C. §§ 1981–2000h-6 (1964).

16. The Supreme Court has noted that tax exemption is a form of governmental financial assistance. Evans v. Newton, 382 U.S. 296 (1966) (state property tax exemption was one of elements of state action); Griffin v. County School Bd. of Prince Edward County, 377 U.S. 218 (1964) (disallowed state tax credit against real estate and personal property taxes for contributions to private segregated schools); Burton v. Wilmington Parking Authority, 365 U.S. 715 (1961). *But see* Guillory v. Administrators of Tulane Univ., 203 F. Supp. 855 (E.D. La.), *vacated*, 207 F. Supp. 554 (E.D. La.), *aff'd*, 306 F.2d 489 (5th Cir. 1962). The propriety of using the federal tax laws to further other areas of public policy is unsettled. *Compare* Tank Truck Rentals v. Commissioner, 356 U.S. 30 (1958) (taxpayer who could not operate profitably without violating maximum weight limitations denied business deduction because such a deduction would frustrate sharply defined public policy), *with* Commissioner v. Sullivan, 356 U.S. 27 (1958) (refusal to use tax laws to enforce other policies).

history of this Act indicates that "financial assistance" was meant to include both direct grants and indirect benefits.[17] Since tax-exempt status and tax deductibility are indirect financial benefits, a racially restrictive organization should be denied this benefit under the terms of the Civil Rights Act. It is hoped that the Internal Revenue Service will complement its significant first step and extend the instant ruling to all charitable organizations described in section 501(c)(3) and to all contributions to charitable organizations under section 170(c)(2)(B).

17. *See* 110 CONG. REC. 2467 (1967) (remarks of Rep. Celler (Dem. N.Y.)): "In general, it seems rather anomalous that the Federal Government should aid and abet diserimination on the basis of race, color or national origin by granting money and other kinds of financial aid."