University of Pennsylvania Law Review

FOUNDED 1852

Formerly
American Law Register

VOLUME 124

JANUARY 1976

NUMBER 3

SOME THOUGHTS ON THE FEDERAL SECURITIES LAWS REGULATING EXTERNAL INVESTMENT MANAGEMENT ARRANGEMENTS AND THE ALI FEDERAL SECURITIES CODE PROJECT*

ALAN ROSENBLAT†
MARTIN E. LYBECKER††

I. INTRODUCTION	589
II. THE INVESTMENT COMPANY ACT	590
A. <i>The Regulatory Framework</i>	590
B. <i>Recommendations to Cure Errors, Omissions, and Needless Complexities</i>	600

* The authors are, respectively, Chief Counsel and former attorney in the Office of Chief Counsel, Division of Investment Management Regulation, Securities and Exchange Commission. The Commission, as a matter of policy, disclaims responsibility for the private publications of its employees. The views expressed herein are those of the authors and do not necessarily reflect the views of the Commission or of the authors' present or former colleagues on the staff. The authors also have advised Professor Louis Loss, the Reporter for the American Law Institute Federal Securities Code, and Professor Victor Brudney, the Assistant Reporter for the Investment Company Act portion (Part XI) of the ALI Code, on matters within the scope of this Article; the views expressed herein do not necessarily reflect the views of Professors Loss or Brudney or any of the ALI Code's consultants or advisers.

† B.A. 1951, J.D. 1954, University of Chicago. Member, New York and Illinois Bars.

†† Visiting Associate Professor of Law, State University of New York at Buffalo. B.B.A. 1967, J.D. 1970, University of Washington; LL.M. 1971, New York University; LL.M. 1973, University of Pennsylvania. Member, Washington and District of Columbia Bars.

1. The Scope of the Act: Definitions and a Prohibition	600
a. <i>Definition of "Investment Company"</i>	600
(i) Alternatives for Inadvertent Investment Companies	603
(ii) Recommended Changes in Section 3(a)(3)	606
(iii) Recommended Change in Section 3(b)	610
(iv) Recommended Changes in Section 3(c)(1)	611
(v) Recommended Change in Section 3(c)(6)	613
b. <i>Definition of "Insurance Company"</i>	614
(i) Parity with Banks	615
(ii) Types of Insurance Activities Permitted	617
(iii) Conclusion and Recommendation	620
c. <i>Definition of "Bank"</i>	620
d. <i>Registration of Foreign Investment Companies</i>	622
e. <i>Definition of "Affiliated Person"</i>	625
f. <i>Definitions of Terms Not Currently Defined</i>	626
2. Fundamental Investment Policy	628
3. Regulation of Investment Company Transactions and Conflicts of Interest	629
a. <i>Services Rendered to an Investment Company</i> ..	629
(i) "Investment Company Manager": Recommended Changes in Sections 2, 15, and 36	633
(ii) Selling Services: Recommended Changes in Sections 17(a) and 17(b)	634
b. <i>Oversight in Sections 17(a) and 17(b)</i>	635
(i) The Oil and Gas Investment Act	635
(ii) Comparison of Oil and Gas Bill Provisions with Recommended Proviso to Section 17(b)	638
(iii) Recommendations	640
c. <i>Section 17(d) Generally</i>	643
(i) The Exceptions Under Rule 17d-1	645
(ii) The Oil and Gas Bill	646
(iii) Comparison of Oil and Gas Bill Provisions with Rule 17d-1	646
d. <i>Recommended Changes to Section 17(d)</i>	649
(i) Prior Approval Procedure	649

(ii)	Standard for Review	650
(iii)	Joint Applicability of Sections 17(a) and 17(d)	651
e.	<i>The Portfolio Affiliate Problem</i>	651
III.	THE INVESTMENT ADVISERS ACT	654
A.	<i>The Regulatory Framework</i>	654
B.	<i>Recommendations to Cure Errors, Omissions, and Needless Complexities</i>	660
1.	Definition of "Investment Adviser"	660
2.	Exceptions to Registration	663
3.	Financial and Professional Responsibility	665
4.	Self-Regulation	665
5.	Mini-Accounts	666
a.	<i>The SIAS Case</i>	666
b.	<i>The Advisory Committee Report</i>	667
c.	<i>Recommendations Regarding Mini-Accounts</i> ...	670
IV.	RECOMMENDATIONS TO REMOVE EXCLUSIONS FROM IN- VESTMENT COMPANY ACT-TYPE REGULATION	673
A.	<i>ICC Companies</i>	673
B.	<i>Oil and Gas Programs</i>	678
C.	<i>Real Estate and Other Tax Shelter Vehicles; REITs</i>	680
V.	CONCLUSION	685

I. INTRODUCTION

The Investment Company Act of 1940¹ and the Investment Advisers Act of 1940² have not yet been the subject of a formal

¹ The Investment Company Act was originally enacted in 1940, Act of Aug. 22, 1940, ch. 686, tit. I, §§ 1-53, 54 Stat. 789, and was in many respects substantially modified by the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, §§ 2-22, 29, 30, 84 Stat. 1413 (codified at 15 U.S.C. §§ 80a-1 to a-52 (1970)). Subsequently, § 18 of the Act, 15 U.S.C. § 80a-18 (1970), was amended by the Act of Oct. 27, 1972, Pub. L. No. 92-595, § 2(g), 86 Stat. 1316, and § 27 of the Act, 15 U.S.C. § 80a-27 (1970), was amended by the Act of Nov. 23, 1971, Pub. L. No. 92-165, 85 Stat. 487 (codified at 15 U.S.C. §§ 80a-18, a-27 (Supp. III, 1973)) (capital structure of investment companies; periodic payment plans). The Securities Acts Amendments of 1975, Pub. L. No. 94-29, §§ 27-28, 89 Stat. 163, amended §§ 9, 10, 13, 15, 16, 18, 32, 36, and 49 of the Act (codified at 15 U.S.C.A. §§ 80a-9, a-10, a-13, a-15, a-16, a-18, a-31, a-35, a-48 (Supp., Aug. 1975)).

To simplify citations, all references will be to the section numbers of the 1940 Act and corresponding United States Code citations will be omitted. From §§ 1 to 28 the Act and code references are parallel. *E.g.*, § 2 of the Act is 15 U.S.C. § 80a-2. From § 80a-29 of the code, § 30 of the Act, the section number in the code is one less than that in the Act. *E.g.*, § 45 of the Act is 15 U.S.C. § 80a-44.

² The Investment Advisers Act was originally enacted in 1940, Act of Aug. 22, 1940, ch. 686, tit. II, §§ 201-21, 54 Stat. 847, and was amended in some respects by the

tentative draft of the American Law Institute's Federal Securities Code (ALI Code) project.³ Although Professor Louis Loss, Reporter for the Code, initially intended merely to incorporate the provisions of these statutes in the ALI Code, he recently has indicated his interest in considering major substantive changes in the two 1940 Acts.⁴ Accordingly, one purpose of this Article will be to suggest—for consideration by Professor Loss; Professor Victor Brudney, Assistant Reporter for the Code's investment company portion; and the ALI—certain changes, some minor and others substantive, designed to correct errors, fill inadvertent legislative gaps, and remove needless complexities in the present statutes. A second purpose is to suggest that Professors Loss and Brudney and the ALI consider substantive modifications that would extend a regulatory environment, based on the framework of the two Acts, to some externalized investment management arrangements not currently so regulated. Although the proposed extensions might result in some restructuring of the tax shelter, oil and gas drilling fund, and investment management industries, we suggest that any such restructuring in response to an improved regulatory environment would be in the public interest and for the protection of investors. Because of the specialized nature of the legislation, specific recommendations for changes in each Act will be prefaced by a summary of its general coverage and most important provisions.

II. THE INVESTMENT COMPANY ACT

A. *The Regulatory Framework*⁵

By drastically curtailing the permissible activities of unregistered investment companies, section 7 of the Investment Com-

Investment Company Amendments Act of 1970, Pub. L. No. 91-547, §§ 23-26, 30, 84 Stat. 1430 (codified at 15 U.S.C. §§ 80b-1 to b-21 (1970)). The Securities Acts Amendments of 1975, Pub. L. No. 94-29, §§ 27, 29, 89 Stat. 163, amended §§ 203, 204, and 217 of the Act (codified at 15 U.S.C.A. §§ 80b-3, b-4, & b-17 (Supp., Aug. 1975)).

To simplify citations, all references will be to the section numbers of the 1940 Act and corresponding United States Code citations will be omitted. The original and codified section numbers are parallel. *E.g.*, § 205 of the Act is 15 U.S.C. § 80b-5.

³ ALI FED. SEC. CODE (Tent. Draft No. 4, 1975); *id.* (Rev. Tent. Draft Nos. 1-3, 1974).

⁴ Compare Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27, 36-37 (1969), with ALI FED. SEC. CODE xvi (Tent. Draft No. 4, 1975). Part XI of the ALI Code will deal with investment companies; Part VII will consolidate the registration provisions for brokers, dealers and investment advisers. *Id.* xv.

⁵ For reviews of the legislative history of the Investment Company Act, see North, *A*

pany Act in effect compels any "investment company" to register under section 8. The term "investment company" is defined broadly in section 3(a) to include any issuer⁶ which:

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;⁷

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificates outstanding;⁸ or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire invest-

Brief History of Federal Investment Company Legislation, 44 NOTRE DAME LAW. 667 (1969); Survey, *The Mutual Fund Industry: A Legal Survey*, 44 NOTRE DAME LAW. 732, 794-808 (1969) [hereinafter cited as *Mutual Fund Survey*]. As these articles discuss more fully, the legislative history of specific provisions in the Investment Company Act is frequently opaque, largely as a result of the Act's tortuous progress through Congress. At the direction of Congress the Commission conducted a massive five-year study of so-called investment trusts, transmitted parts of the study to Congress, and prepared the bills that were initially introduced. Because of the breadth and scope of the study, specific provisions in the initial bills can be correlated with specific abuses identified in the study only with difficulty; cross-indexing can be done with little assurance of absolute accuracy. This difficulty is compounded enormously by the fact that the bills ultimately considered and passed by Congress emanated from Commission/industry negotiations that commenced after the industry voiced strong opposition to the initial bills. Strictly speaking, the "legislative history" of the bills which ultimately passed consists solely of their provisions being read into the record with relatively brief comments by the parties concerned.

Congressional intent, however, may be gleaned by diligently tracing the evolution of particular provisions from bill to bill. See, e.g., notes 64, 178 & 215-18 *infra*.

⁶ An issuer of securities is, of course, typically a company. "Company" is defined broadly in § 2(a)(8) as "a corporation, a partnership, an association, a joint-stock company, a trust, a fund, or any organized group of persons whether incorporated or not . . ." A company need not be a "recognizable business entity." *Prudential Ins. Co. of America v. SEC*, 326 F.2d 383 (3d Cir.), cert. denied, 377 U.S. 953 (1964); see *SEC v. Variable Annuity Life Ins. Co. of America*, 359 U.S. 65 (1959).

⁷ The definition of "security" in § 2(a)(36) is identical to that in § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970). The Commission staff has interpreted the two sections in a consistent manner. See, e.g., *Moultrie Nat'l Bank*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,081 (SEC staff letter, Nov. 27, 1974); *Arthur E. Fox*, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,082 (SEC staff letter, Nov. 12, 1974).

⁸ The term "face-amount certificate" is defined in § 2(a)(15). Certain of these securities are further defined as being installment type securities. Section 28 generally governs issuers of such securities of the installment type. See SECURITIES & EXCHANGE COMM'N, PUBLIC POLICY IMPLICATIONS OF INVESTMENT COMPANY GROWTH, H.R. REP. NO. 2337, 89th Cong., 2d Sess. 37-38 (1966) [hereinafter cited as PUBLIC POLICY IMPLICATIONS]. For a discussion of the effect of the Investment Company Amendments Act of 1970 on face-amount certificate companies, see SEC Investment Company Act Release No. 6392, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,984 (Mar. 19, 1971).

ment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.⁹

As used in this section, "investment securities" includes all securities except (A) Government securities, (B) securities issued by employees' securities companies, and (C) securities issued by majority-owned subsidiaries of the owner which are not investment companies.

Because of the breadth of the definition of "investment company," a number of statutory exclusions are specified in sections 3(b) and 3(c). Excluded are: industrial and certain types of holding companies primarily engaged in other businesses (sections 3(b)(1)-(b)(3));¹⁰ broker-dealers (section 3(c)(2)); banks, insurance companies,¹¹ and savings and loan associations (section 3(c)(3)); companies regulated or supervised by the Interstate Commerce Commission or by the SEC under the Public Utility Holding Company Act of 1935 (sections 3(c)(7),¹² 3(c)(8)); and single or collective pension and profit-sharing plans qualified under section 401 of the Internal Revenue Code (section 3(c)(11)). Also excluded are: persons substantially all of whose business is confined to commercial financing and other money lending activities (sections 3(c)(4), 3(c)(5)(A) and (B)); funds consisting of securities related to oil and gas interests and companies purchasing real estate and whole mortgages (sections 3(c)(9)¹³ and 3(c)(5)(C));¹⁴ certain charitable, educational, and religious organizations (section 3(c)(10)); and voting trusts and security holders' protective committees (sections 3(c)(12) and 3(c)(13)). Finally, presumably because of the lack of significant public interest, an investment company that has fewer than 100

⁹ The full sweep of the investment company definition in § 3(a)(3) has yet to be determined. The definition's expansive nature, taking in companies that have unintentionally stumbled into investment company status, has been criticized. For good discussions of the development of the applicability of § 3(a)(3), see Kerr, *The Inadvertent Investment Company: Section 3(a)(3) of the Investment Company Act*, 12 STAN. L. REV. 29 (1959); Kerr & Appelbaum, *Inadvertent Investment Companies—Ten Years After*, 25 BUS. LAW. 887 (1970). See also SEC v. Fifth Ave. Coach Lines, Inc., 435 F.2d 510 (2d Cir. 1970); Garrett, *When Is An Investment Company?*, 37 U. DET. L.J. 355 (1960). For a discussion of proposed refinements of the definition, see text accompanying notes 47-71 *infra*.

¹⁰ See text accompanying notes 72-73 *infra*.

¹¹ See text accompanying notes 82-109 *infra*.

¹² See text accompanying notes 290-304 *infra*.

¹³ See text accompanying notes 305-12 *infra*.

¹⁴ See text accompanying notes 313-29 *infra*.

shareholders and is neither making nor proposing to make a public offering of its securities is excluded from the definition of investment company by section 3(c)(1).¹⁵

Predominant among the entities remaining within the investment company definition are diversified,¹⁶ open-end¹⁷ investment companies, popularly known as "mutual funds."¹⁸ The unique characteristics of the investment company industry have led to an unusual regulatory framework. A fund's assets, usually consisting of a large pool of cash and securities, are highly liquid and highly vulnerable. Those involved in fund management and share distribution both have structural incentives to see that fund shares are aggressively marketed. Externalized management, which is prevalent in the industry, provides investment advice and managerial services for a fee which is generally a fixed percentage of the amount of assets under management.¹⁹

¹⁵ See text accompanying notes 74-80 *infra*.

¹⁶ "Diversified company" is defined in § 5(b)(1) as a management company with 75% of its assets limited to securities representing not more than 10% of the outstanding voting securities of any one company and not more than 5% of its total assets in the securities of any one company. Any investment company other than a diversified company is non-diversified. Section 5(b)(2). The principal advantage of diversification is the special tax treatment afforded such investment companies under subchapter M of the Internal Revenue Code (which uses a somewhat different test). See INT. REV. CODE OF 1954, §§ 851-55. Diversified investment companies that distribute at least 90% of their ordinary income in the form of dividends avoid double taxation on both the distributed income and on certain long-term capital gains. For a thorough explanation of the special tax treatment afforded diversified investment companies, see PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 79-82.

¹⁷ "Open-end company" is defined as a management company that is offering for sale or has outstanding a redeemable security that it issued. A closed-end company is any other management company. Section 5(a). A redeemable security is one that entitles the holder, upon presentation to the issuer, to receive approximately his proportionate share of the issuer's current net assets or the cash equivalent. Section 2(a)(32).

¹⁸ In the 1920's, closed-end funds predominated. Net assets in mutual funds did not exceed those in closed-end funds until 1944. By 1966, 379 registered mutual funds had \$38.2 billion in total assets under management, while 149 active closed-end funds had \$6.6 billion in total assets. PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 43-44. By December 1970, mutual funds had \$54 billion in total assets under management. 2 SECURITIES & EXCHANGE COMM'N, INSTITUTIONAL INVESTOR STUDY REPORT, H.R. DOC. NO. 64, 92d Cong., 1st Sess., at 139 (1971) [hereinafter cited as IIS REPORT]. A recent calculation published by the Investment Company Institute, the trade association for mutual funds, indicates that mutual funds presently have \$43.2 billion in total assets under management, of which \$2.5 billion is held by so-called money-market funds. Wall St. J., April 23, 1975, at 29, col. 4. It is unclear how much of the drop is attributable to depressed market prices, poor investment performance, or poor sales. For an introduction to the investment company industry, see *Mutual Fund Survey*, *supra* note 5, at 740-58.

¹⁹ For discussions of the role of fund managers and the current debate over the fees paid to external managers, see PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 83-154; *Conference on Mutual Funds: The Mutual Fund Management Fee*, 115 U. PA. L. REV. 726

Assets, of course, may be increased not only by skillful investment management but also by heavy promotion leading to extensive sales of fund shares. The distribution network involves a principal underwriter, a broker-dealer, and a registered representative. Typically the costs of the network are charged to the ultimate buyer as the sales load, which is usually expressed as a percentage of the total purchase price and is specified in the mutual fund's prospectus.²⁰ Responsive to the highly liquid nature of a mutual fund's assets and to the pressure to adopt aggressive marketing tactics, the Investment Company Act is unlike other federal securities laws in going beyond minimum disclosure requirements to establish a comprehensive regulatory scheme for the sale of shares and management of assets.

First, many of the provisions of the Investment Company Act are intended to prevent or inhibit outright fraud. Section 9 prohibits persons convicted of or enjoined from committing certain types of misconduct from becoming any part of the investment company industry. Section 37 makes larceny, conversion, or embezzlement of investment company assets a federal crime. Section 36(a) authorizes the Commission to obtain injunctions against persons associated with investment companies for a breach of fiduciary duty involving personal misconduct. Section 36(b), added by the Investment Company Amendments Act of 1970,²¹ authorizes the Commission or a shareholder to bring

(1967) [hereinafter cited as *Management Fee*]; *Mutual Fund Survey*, *supra* note 5, at 881-956.

²⁰ For descriptions of mutual fund sales distribution systems, see PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 201-21; Division of Investment Management Regulation, Securities & Exchange Comm'n, *Mutual Fund Distribution and Section 22(d) of the Investment Company Act of 1940*, in CCH MUTUAL FUNDS GUIDE No. 155, pt. II (1974); *Conference on Mutual Funds: The Financing of Sales of Mutual Fund Shares*, 115 U. PA. L. REV. 769 (1967); *Mutual Fund Survey*, *supra* note 5, at 813-51. The Supreme Court recently discussed the history and goals of regulation of mutual fund distribution in *United States v. National Ass'n of Sec. Dealers, Inc.*, 422 U.S. 694 (1975).

²¹ Pub. L. No. 91-547, 84 Stat. 1413. During 1971, the Commission issued several releases interpreting certain provisions of the Amendments Act. *E.g.*, SEC Investment Company Act Release Nos. 6336, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,951 (Feb. 2, 1971) (application of "interested person" concept; approval of certain performance-based advisory contracts); 6430, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,019 (April 2, 1971) (insurance company separate accounts); 6440, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,022 (April 6, 1971) (repeal of exclusions for certain companies; limitations on pyramiding of investment companies); 6568, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,125 (June 11, 1971) (guidelines for additional disclosures concerning new refund and election provisions affecting periodic payment plan certificates); 6863, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,449 (Dec. 6, 1971) (guidelines relating to checking accounts for

actions against persons associated with an investment company with regard to the investment advisory fee, compensation for services, or any payments of a material nature.²² Section 31 authorizes the Commission to prescribe accounting policies and practices; section 32 requires investment company financial statements to be certified by independent public accountants whose selection must be ratified by an investment company's shareholders.

Certain paragraphs in section 17, the Investment Company Act's conflict of interest provisions, also contain important anti-fraud protections. The Commission is authorized to establish bonding requirements²³ and to adopt rules governing custody of investment company portfolio securities.²⁴ An investment company is prohibited from protecting any officer or director of the

companies with bank custodians). For a history of the Investment Company Amendments Act of 1970, see North, *The Investment Company Amendments Act of 1970*, 46 NOTRE DAME LAW. 712 (1971). For comments on § 36 as amended by the 1970 Act, including a discussion of the availability of private rights of action, see Freedman & Rosenblat, *Duties to Mutual Funds*, 4 REV. SEC. REG. 937 (1971). For a discussion of the SEC's report, *Public Policy Implications of Investment Company Growth* (see note 8 *supra*) and its recommendations that led up to the 1970 Act, see Werner, *Protecting the Mutual Fund Investor: The SEC Reports on the SEC*, 68 COLUM. L. REV. 1 (1968).

²² See North, *supra* note 21, at 726-28. Section 36(b)(1) states that a plaintiff shall have the burden of proving a breach of fiduciary duty and that it is not necessary to allege or prove personal misconduct. Section 36(b)(2) permits a court to give such consideration as may be appropriate to the fact that an investment company's board of directors has approved the payments at issue. Section 36(b)(3) limits recovery of damages to the period ending one year prior to commencement of the action and precludes recovery of actual damages in excess of the amount of compensation received by the associated person. Section 36(b)(4) excludes from direct attack under § 36 payments that are subject to § 17 or are sales loads paid in a share-for-share or share-for-assets acquisition by a registered investment company. Section 36(b)(5) provides exclusive federal jurisdiction for actions brought under § 36. See Freedman & Rosenblat, *supra* note 21, at 937-38. In Carl L. Shipley, SEC Investment Company Act Release No. 8394, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,833 (June 21, 1974), the Commission held that § 36(a)—and by dictum implied that § 36(b)—cannot be used as the sole basis for an implied grant of power to conduct administrative proceedings. See also *Boyko v. Reserve Fund, Inc.*, [Current] CCH FED. SEC. L. REP. ¶ 95,304 (S.D.N.Y. Sept. 30, 1975) (demand for board action prior to filing a derivative action presumed to be futile where action is to be brought under § 36(b) and at least one interested director sits on the fund's board). Finally, § 36(b)(6) prevents adverse court verdicts under § 36 from (1) being used to disqualify a person under §§ 9 and 49 [Note that the cross reference in 15 U.S.C. § 80a-35(b)(6) (1970) to § 80a-49 is erroneous; the reference should be to § 80a-48. Investment Company Amendment Act of 1970, Pub. L. No. 91-547, § 20, 84 Stat. 1428.] of the Investment Company Act, § 203 of the Investment Advisers Act, or § 15 of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78o (Supp., Aug. 1975), amending 15 U.S.C. § 78o (1970), or (2) being used to enjoin the person from further association with the investment company.

²³ Section 17(g); rule 17g-1, 17 C.F.R. § 270.17g-1 (1975).

²⁴ Section 17(f); rules 17f-1, 17f-2, 17 C.F.R. §§ 270.17f-1, 17f-2 (1975).

company or its investment adviser or principal underwriter from liability for "willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties" ²⁵ The Commission is authorized to adopt rules to prevent fraudulent or deceptive practices in connection with the purchase or sale of securities held or intended to be acquired by an investment company, and to require adoption of codes of ethics by investment companies and their investment advisers and principal underwriters. ²⁶

Second, section 18 of the Investment Company Act contains important restrictions on investment company capital structures. Every share of stock issued by a registered management-type ²⁷ investment company must have voting rights equal to those of every other outstanding share of stock. ²⁸ Registered open-end investment companies cannot issue any senior securities, ²⁹ while

²⁵ Section 17(i); § 17(h).

²⁶ Section 17(j). This section was added by the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 9(c), 84 Stat. 1420, but the Commission has not yet exercised the rulemaking power that was granted. See SEC Investment Company Act Release No. 7581, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,157 (Dec. 26, 1972) (proposed rule 17j-1).

The proposed rule would, *inter alia*, implement the congressional policy of declaring unlawful "insider trading" by affiliated and access persons of an investment company in securities the company *holds or intends to acquire*. See § 17(j). The rule would, within its limits, give the Commission and probably an investment company a right of action against the "insider" whether or not the company is a purchaser or seller of the security in question. This broad right is especially important because recent judicial interpretations may deny to an investment company that is not a purchaser or seller of securities a cause of action under rule 10b-5, 17 C.F.R. § 240.10b-5 (1975). *E.g.*, *Blue Chip Stamps v. Manor Drug Stores*, 95 S. Ct. 1917 (1975).

The code of ethics requirement in proposed rule 17j-1 is also important. For a discussion of the problems of disclosure of investment advice, see Fleischer, Mundheim & Murphy, *An Initial Inquiry Into the Responsibility to Disclose Market Information*, 121 U. PA. L. REV. 798, 824-40 (1973).

²⁷ The Investment Company Act provides for three different types of investment companies: face-amount certificate companies, discussed at note 8 *supra*; unit investment trusts, defined in § 4(2), which are governed generally by the provisions of § 26 of the Act; and all others, which in § 4(3) are termed management companies.

²⁸ Section 18(i). This requirement of "shareholder democracy" may produce irreconcilable problems when a limited partnership is found to be within the investment company definition and is unable to satisfy any of the statutory exclusions. Careful structuring may successfully finesse the problem by avoiding characterization of the partnership as an "investment company." See, *e.g.*, SEC Investment Company Act Release No. 8456, 4 CCH FED. SEC. L. REP. ¶ 47,357 (Aug. 9, 1974) (two-tier real estate companies).

²⁹ Section 18(f)(1). The scope of the general definition of "senior security" in § 18(g) is limited for registered open-end companies by § 18(f)(2). The companies may borrow from banks if asset coverage is a minimum of 300% or in other limited circumstances. See § 18(f)(1); rule 18f-1, 17 C.F.R. § 270.18f-1 (1975). When a company issues securities that but for § 18(f)(2) would be senior, the Commission is authorized to prescribe special voting rights for the security holders. See rule 18f-2, 17 C.F.R. § 270.18f-2 (1975).

closed-end funds can issue senior securities only where asset coverage is 300% (debt securities) or 200% (preferred stock).³⁰ Section 12 augments the capital structure restrictions of section 18 by giving the Commission rulemaking authority over margin buying³¹ and short sales of securities³² and by imposing severe restrictions on investments in securities of other issuers in the investment company,³³ insurance,³⁴ and securities industries.³⁵

Third, section 10 of the Act places strict limitations on the composition of the board of directors of a registered investment company. No less than forty percent of most boards must consist of persons who are not officers, directors, employees or other "interested persons" of the investment company, its investment adviser, or its principal underwriter.³⁶ Further restrictions are imposed on the board depending on relationships between the investment company and brokers, underwriters and investment bankers.³⁷ These limitations on the composition of the board of directors help to insure that someone in a position of power will serve a "watchdog" function on behalf of investment company shareholders, especially in situations involving the possible conflicts of interest of external investment advisers.³⁸

³⁰ Sections 18(a)(1)(A), 18(a)(1)(B). The terms "senior security" and "asset coverage" are defined in §§ 18(g) and 18(h) respectively.

³¹ Section 12(a)(1).

³² Section 12(a)(3).

³³ Section 12(d)(1). This section was extensively amended in 1970 to deal with the problems of mutual fund holding companies. The Commission had proposed abolition of such companies. See PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 323; North, *supra* note 21, at 720-21 & n.38.

³⁴ Section 12(d)(2).

³⁵ Section 12(d)(3). Rule 12d-1, 17 C.F.R. § 270.12d-1 (1975), conditionally exempts certain limited purchases or acquisitions of securities from the prohibitions of § 12(d)(3).

³⁶ Section 10(a). "Interested person" is a very broad and intricate term of art defined in § 2(a)(19). A subset of "interested person" of an investment company is "affiliated person" of the company. The latter term is defined in § 2(a)(3). For the legislative history of "interested person," see North, *supra* note 21, at 718-20. Certain no-load funds have less stringent requirements. Section 10(d).

³⁷ See §§ 10(b)(1)-(b)(3). The applicability of these provisions is contingent upon a director, officer or employee or a related person of one of these persons being employed as broker or principal underwriter of the company or on a director, officer or employee being an investment banker or an affiliated person of an investment banker. For the definitions of "broker," "principal underwriter," and "investment banker," see, respectively, §§ 2(a)(6), 2(a)(29) & 2(a)(21). Section 10(c) further prohibits persons who are officers, directors, or employees of any one bank from constituting a majority on the board.

³⁸ See Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. PA. L. REV. 179, 230-64 (1971). Added in 1970, § 15(c) requires that a majority of the disinterested directors approve investment advisory and principal underwriting contracts. It also states that they have a duty to request and evaluate "such information as may be reasonably

Finally, in what many observers feel is the heart (and perhaps the principal roadblock) of the Investment Company Act, certain subsections in section 17 prohibit various conflict of interest transactions between an investment company and its investment adviser, principal underwriter, or other "affiliated" persons³⁹ unless advance Commission approval has been obtained.⁴⁰ Thus, section 17(a) generally prohibits any affiliated person (or any affiliated person of such affiliated person) of a registered investment company knowingly from selling, purchasing, or borrowing securities or other property from the investment company.⁴¹ Section 17(d) generally empowers the Commission to establish rules and procedures tightly restricting any affiliated person (or any affiliated person of such affiliated person) of a registered investment company acting as principal from effecting any transaction in which the investment company (or a company controlled by the registered investment company) is a joint or joint and several participant with the affiliated person.⁴² Section 15 contains important safeguards for the execu-

necessary to evaluate the terms" of the investment advisory contract. It will be recalled that § 36(b), which also was added by the 1970 amendments, specifies that the investment adviser has a fiduciary duty with respect to the receipt of compensation for services or of any payments of a material nature. The legislative history of this provision, and the controversy preceding its adoption are discussed in Freedman & Rosenblat, *supra* note 21, at 738-39; North, *supra* note 21, at 721-22; Nutt, *supra*, at 238-51. For a pre-1970 Act discussion of the factors that independent directors ought to consider to properly fulfill their role, see Mundheim, *Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds*, 115 U. PA. L. REV. 1058 (1967).

³⁹ The broad definition of "affiliated person," § 2(a)(3), can lead to very complex results. For example, on the problems raised when a portfolio company becomes an affiliated person of an investment company, see Kroll, *The "Portfolio Affiliate" Problem*, in *THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION* 261 (R. Mundheim & A. Fleischer, Jr. eds. 1972); Comment, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. PA. L. REV. 983 (1972). See text accompanying notes 205-19 *infra*.

⁴⁰ For the procedure for prior approval, see rules 0-2, 0-5, 17 C.F.R. §§ 270.0-2, 0-5 (1975). The standard for granting an order is found in various provisions, such as § 2(a)(9) ("control") and § 2(a)(19) ("interested person"). Section 6(c) provides generally that exemptive orders may be granted by the Commission "if and to the extent such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of this title." Section 17 itself provides standards for certain exemptions. Sections 17(b) & 17(d).

⁴¹ Sections 17(a)(1)-(a)(3). The Commission has adopted a series of rules under § 17(a) that exempt certain specified transactions from the prohibitions of § 17(a) in circumstances in which the need for Commission review is remote, and which thereby obviate the need for filing applications requesting an exemptive order provided for in § 17(b). See rules 17a-1 to a-7, 17 C.F.R. §§ 270.17a-1 to a-7 (1975).

⁴² The Commission has also adopted a rule that sets forth the standard for review of

tion of contracts between the investment company and its investment adviser and principal underwriter,⁴³ and section 17(e) limits the amount of compensation that affiliated persons acting as brokers may receive from the investment company.⁴⁴

an application for an exemption from § 17(d), defines the term "joint enterprise or other joint arrangement or profit-sharing plan," and exempts from the prohibition of § 17(d) certain specified transactions in circumstances in which the possibility of the investment company involving itself in disadvantageous arrangements is remote. See rule 17d-1, 17 C.F.R. § 270.17d-1 (1975); text accompanying notes 177-205 *infra*.

While § 17(d) authorizes the Commission to adopt rules prohibiting joint transactions where the evidence establishes merely that *the investment company* is participating in the joint transaction on a basis different from or less advantageous than the other participants, § 17(b) permits the Commission to grant exemptive orders from § 17(a) limitations only where: (1) the terms of the proposed transaction are reasonable and fair, and do not involve overreaching *on the part of any person concerned*; (2) the proposed transaction is consistent with the formal investment policy of each registered investment company participant; and (3) the proposed transaction is consistent with the general purposes of the Investment Company Act. Thus, the scope of Commission inquiry regarding a § 17(b) application is somewhat wider than that required for granting a § 17(d) application. See, e.g., Bowser, Inc., SEC Investment Company Act Release No. 4842, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,435 (Feb. 8, 1967). There an affiliated person (Bowser) of an affiliated person (Sterling Precision Corp.) of an investment company (Equity Corp.) proposed to buy its own (Bowser) shares from Sterling, Equity, and others. The Commission refused to grant a § 17(b) exemption because, *inter alia*, under state law Bowser management would breach its fiduciary duty by using corporate funds to maintain control.

⁴³ Section 15(c), see note 38 *supra*, requires that a majority of the disinterested directors approve the investment advisory and underwriting contracts, and imposes on those directors the duty to request and evaluate such information as may be reasonably necessary to evaluate the terms of such agreements. The disinterested directors are required by § 15(c) to cast their votes in person at a meeting called for the purpose of voting on the contracts. SEC Investment Company Act Release No. 6336, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,951 (Feb. 2, 1971). Section 15(a) requires that investment advisory contracts be in writing, be approved by a majority of the shareholders entitled to vote, precisely describe all compensation to be paid thereunder, and provide for termination upon 60 days' written notice or automatically in the event of its assignment. "Assignment" is defined in § 2(a)(4) of the Act. Both investment advisory and underwriting contracts may be for terms of greater than two years if their continuance after the first two years is approved annually by the board of directors or by vote of a majority of the shareholders entitled to vote and by a majority of the disinterested directors. See §§ 15(a)(2), 15(b)(1), 15(c). For rules exempting certain investment advisory contracts from the strict provisions of § 15, see rules 15a-1 (small investment advisory contracts) and 15a-3 (certain registered separate accounts), 17 C.F.R. §§ 270.15a-1 & 15a-3 (1975).

⁴⁴ Section 17(e) prohibits any affiliated person (or affiliated person of such person) of a registered investment company when: (1) *acting as agent*, from accepting any compensation from any source for the purchase or sale of any property to or from the investment company except in the course of the person's business as an underwriter or broker; or (2) *acting as broker*, in connection with the sale of securities to or by the investment company, from receiving from any source a commission, fee, or other remuneration which exceeds (A) the usual and customary brokerage commission if the sale is executed on a securities exchange, (B) 2% of the sales price if executed in a secondary distribution, or (C) 1% of the sales price if otherwise effected. Section 17(e)(2)(C) gives the Commission rulemaking power, which it has not exercised, to permit larger commis-

B. *Recommendations to Cure Errors, Omissions,
and Needless Complexities*

This section will recommend changes in the Investment Company Act to cure certain legislative errors and omissions. It will suggest the reworking of the scope of some provisions, such as sections 3(a)(3) and 17, to remove inconsistencies and complexities that cause affected persons inordinate problems while not appearing to provide any tangible degree of investor protection. Many of these recommendations and those concerning the Investment Advisers Act⁴⁵ have already been made to (and tentatively accepted by) Professors Loss and Brudney. One advantage of reiterating them here is to articulate fully their "legislative" history for the benefit of critical comments and analysis by other persons interested in the regulation of external investment management relationships.

1. The Scope of the Act: Definitions and a Prohibition

a. *Definition of "Investment Company"*⁴⁶

The subject of the Act, the investment company, is defined in several manners. The alternative that has been most troublesome, contained in section 3(a)(3), defines such a company as any issuer which:

is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.

As used in this section, "investment securities" includes all securities except (A) Government securities,⁴⁷ (B)

sions if they are in the public interest and consistent with the protection of investors. With the demise of fixed minimum brokerage commissions on national securities exchanges pursuant to Securities Exchange Act rule 19b-3, 17 C.F.R. § 240.19b-3 (1975), it may be necessary to adopt such rules because of the difficulty of demonstrating what is a "usual and customary" brokerage commission. The problem may not be significant because few trades executed by affiliated broker-dealers for the registered investment company may involve negotiated brokerage commissions in excess of 1%. See also Securities Exchange Act of 1934, §§ 11(a)(1)-(2), 15 U.S.C.A. §§ 78k(a)(1)-(2) (Supp., Aug. 1975), *amending* 15 U.S.C. 78k(a)(1)-(2) (1970).

⁴⁵ See notes 245-89 *infra* & accompanying text.

⁴⁶ See text accompanying notes 6-9 *supra*.

⁴⁷ "Government security" is defined in § 2(a)(16). See ALI FED. SEC. CODE § 301 (Rev.

securities issued by employees' securities companies,⁴⁸ and (C) securities issued by majority-owned subsidiaries⁴⁹ of the owner which are not investment companies.

Generally speaking, section 3(a)(3) may apply to a company during three distinct periods in its life.⁵⁰ First, during the start-up period a company may in the exercise of prudent asset management invest its offering proceeds in securities until it can purchase appropriate assets to begin industrial or other non-investment company operations. A broad spectrum of issuers may be confronted with this problem. Real estate syndications and other tax shelters are particularly vulnerable because of the unusual amount of time needed to analyze, organize, and purchase interests in the particular types of deals appropriate for the specific tax shelter.⁵¹ Second, a company that determines

Tent. Draft Nos. 1-3, 1974). Section 3(a)(1), unlike § 3(a)(3), does not use the term of art "investment security" and therefore government securities are presumably considered in the "primarily engaged" test of § 3(a)(1), but not in the 40% test of § 3(a)(3). A large portfolio consisting solely of "government securities" could bring a company within the "primarily engaged" condition of § 3(a)(1).

⁴⁸ The term "employees' securities company" is defined in § 2(a)(13). Under § 6(b) of the Act, an employees' securities company may, upon application, receive an order from the Commission exempting it from the Act to the extent the exemption is consistent with the protection of investors. Rule 6b-1, 17 C.F.R. § 270.6b-1 (1975) (exemption from the entire Act pending Commission's determination of application for exemptive order).

⁴⁹ Section 2(a)(24) defines "majority-owned subsidiary" as "a company 50 per centum or more of the outstanding voting securities of which are owned" by a person. The exclusion of securities of a "majority-owned subsidiary" implies that a conglomerate operating primarily through majority-owned subsidiaries would be subject to § 3(a)(3) only if (1) 40% of its assets, on an unconsolidated basis, were invested in other securities that fall within the definition of investment securities, or (2) its majority-owned subsidiaries were themselves investment companies. See E. ARANOW & H. EINHORN, *TENDER OFFERS FOR CORPORATE CONTROL* 192-93 (1973) [hereinafter cited as ARANOW & EINHORN].

⁵⁰ See Kerr, *supra* note 9. Some of the issues discussed by Kerr are updated in terms of more current events in Kerr & Appelbaum, *supra* note 9.

⁵¹ E.g., SECURITIES & EXCHANGE COMM'N, REPORT OF THE SEC REAL ESTATE ADVISORY COMMITTEE 50-54 (1972) [hereinafter cited as REAL ESTATE REPORT]. The committee recommended that the Commission deem the Investment Company Act inapplicable to real estate syndications for the gap in time between an offering and subsequent investment of the proceeds, possibly with the proviso that not more than 70% of the proceeds remain invested in securities within 365 days of the offering. The report incorrectly stated (perhaps through a typographical error) the position of the Division of Investment Management Regulation and of its predecessors by suggesting that investment of more than 25%, rather than more than 50%, of an issuer's assets in securities would cause questions about its status under § 3(a)(1) or § 3(a)(3). Compare *id.* 51, with U.S. Bancshares, Inc. [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,789 (SEC staff letter, Feb. 9, 1972). Moreover, few, if any, tax shelter offerings appear to be having problems with the Division's present no-action position described at note 55 *infra*.

The committee's summary of recommendations is reproduced at [1972-1973 Trans-

to sell off a large operating division⁵² or is an aggressor in

fer Binder] CCH FED. SEC. L. REP. ¶ 79,265. For a recent discussion of this "start-up" problem, see Cohen & Hacker, *Applicability of the Investment Company Act of 1940 to Real Estate Syndications*, 36 OHIO ST. L.J. 482, 482-86 (1975).

⁵² See Kerr, *supra* note 9, at 29. The classic case illustrating this problem is SEC v. Fifth Ave. Coach Lines, Inc., 435 F.2d 510 (2d Cir. 1970), *aff'g* 289 F. Supp. 3 (S.D.N.Y. 1968). New York City condemned all of Fifth Avenue's city bus lines in March, 1962, and satisfied a portion of the company's claims in October, 1966. In the interim, including at a shareholders' meeting of August, 1966, management announced its intention to use the proceeds for investment purposes, and did little but litigate its claims. When Fifth Avenue received a condemnation award of \$11,500,000, it began to invest in securities. The Commission sought an injunction against violations of the Securities Exchange and Investment Company Acts and the appointment of a receiver for Fifth Avenue. The district court and the Second Circuit both found Fifth Avenue to be an unregistered investment company from June, 1967, granted the injunction requested, and appointed a receiver. Unfortunately the self-dealing transactions by Fifth Avenue's affiliated persons, as found by the courts, all occurred prior to June, 1967.

The lower court opinion, by Judge McLean, contained several important errors in interpreting the Investment Company Act (which for procedural reasons remained untouched by the Second Circuit).

First, Judge McLean found Fifth Avenue, as of June 30, 1967, to be an investment company within the meaning of §§ 3(a)(1) and 3(a)(3). We disagree that the evidence proffered by the Commission did not support a finding as to applicability of § 3(a)(1) and Fifth Avenue's satisfaction of the "primarily engaged" test prior to June 30, 1967. The test of § 3(a)(1) is the existence, holding out, or proposal of primary engagement. We believe that Fifth Avenue was, as of its annual meeting in August, 1966, holding itself out and proposing to engage primarily in the business of investing in securities as soon as it received the condemnation award. It was not merely predicting future events. Thus, Judge McLean could have found it to be a § 3(a)(1) company as of August, 1966.

Second, Judge McLean ignored the fact that certificates of deposit are plainly securities, and are surely treated as such for purposes of § 3(a)(1). See Josephthal & Co., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,116 (SEC staff letter, Nov. 25, 1974); Arthur E. Fox, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,082 (SEC staff letter, Nov. 12, 1974); Warren W. York & Co., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,758 (SEC staff letter, Dec. 21, 1973); cf. *Tcherepnin v. Knight*, 389 U.S. 332 (1967). We find unsatisfactory Judge McLean's rationale that "a company which has suddenly come into possession of a substantial amount of cash is entitled to a reasonable time to decide what to do with it . . ." 289 F. Supp. at 28. Section 3(a)(1) speaks in terms of "primarily engaged," not "reasonable time."

Third, Judge McLean compounded his error as to § 3(a)(1) by bringing his "reasonable time" test into his analysis of § 3(a)(3). He failed to note the critical inclusion of the word "holding" in § 3(a)(3), which surely contemplates an inactive investment portfolio. Kerr, *supra* note 9, at 34.

Moreover, he also misapplied § 3(a)(3). Here the problem is more subtle. Section 3(a)(3) excludes from the assets test both cash items and government securities. It also defines the term investment security to include all securities except those securities that are excluded. Thus, a certificate of deposit that is a security should be treated as an investment security, not as a cash item, even though the Commission's accounting rules may dictate otherwise for purposes of the form and content of financial statements for operating companies and registered investment companies. Compare regulation S-X § 1-01, 17 C.F.R. § 210.1-01 (1975), with regulation S-X § 6-03-1, 17 C.F.R. § 210.6-03-1 (1975). For other reasons, the Commission has proposed revising § 6-03-1 to remove the language that may have led to confusion in *Fifth Avenue*. See SEC Investment Company Act Release No. 8801, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,179 (May 27, 1975). With the calculations properly reconstructed, Judge McLean could have found

takeovers⁵³ may find itself with more than forty percent of its assets in investment securities. Finally, a company selling off its assets in the process of final liquidation and dissolution could also inadvertently cross the forty-percent line.⁵⁴

(i) Alternatives for Inadvertent Investment Companies

A company that finds itself within the ambit of section 3(a)(3) has several choices.

First, if the problem that caused the large portfolio of securities is temporary, counsel for the company may choose to seek a no-action letter. The Commission staff has issued such letters, stating it would not presently recommend that the Commission take action against the company for failure to register under the Investment Company Act, contingent upon the truth of counsel's representations that the company is engaged in bona fide efforts to get back outside the scope of section 3(a)(3) within the succeeding six months.⁵⁵ Assuming the company can reach

Fifth Avenue to be an investment company within the meaning of § 3(a)(3) at least as of December 31, 1966.

In our view, the Commission's failure to cross-appeal these conclusions as to §§ 3(a)(1) and 3(a)(3) is not legally significant. Although the points were argued and set aside as not properly raised before the Second Circuit, the Commission had already won its major allegations. In view of the court's conceptual errors in interpreting § 3(a)(3), the Commission staff does not follow its opinion in day-to-day administration of the Investment Company Act. John G. Sobieski (SEC staff letter, Mar. 13, 1975) (concerning Lawyers Financial Corp.); Morris & Churchill (SEC staff letter, Nov. 26, 1974) (concerning LectraData, Inc.); Samuel Lippman (SEC staff letter, Oct. 19, 1973).

⁵³ ARANOW & EINHORN, *supra* note 49, at 200-03; Kerr & Appelbaum, *supra* note 9, at 892-99. An unsuccessful tender offeror may find itself with a large investment portfolio, including securities of the target company, which exceeds 40% of its assets. Kerr and Appelbaum have capsulized the "Slick" model for undertakings and for related disclosure of potential Investment Company Act problems under § 3(a)(3) and for the possibility of obtaining exemptive orders from the Commission under § 3(b)(2). *Id.* 895-98 & n.50. We would note only that the emphasis on the language in the MITE Corp. merger proxy statement, *id.* 898-99 n.52, is misplaced: The Commission staff presently adheres to the "Slick" model, *id.* 898, and would take the position that an unsuccessful tender offeror could not rely on self-executing provisions of § 3(b)(1) for exclusion from § 3(a)(3). The offeror would have to file an application for exemption under § 3(b)(2).

⁵⁴ The unnumbered paragraph following § 7(a)(5) provides, however, that the prohibitions of § 7 will not apply "to transactions of an investment company which are merely incidental to its dissolution." Thus, the Commission staff has taken a no-action position as to the need for registration under the Investment Company Act where the company can represent that it is in the process of final dissolution and that all of its activities under applicable state law must be merely incidental to the liquidation and dissolution. Kaplan, Livingston, Goodwin, Berkowitz & Selvin (SEC staff letter, May 17, 1973) (concerning Wrather Corp.).

⁵⁵ *E.g.*, Morris & Churchill (SEC staff letter, Nov. 26, 1974) (concerning LectraData, Inc.).

The Commission staff has taken the position that, in terms of the "primarily en-

its goal, the risk, of course, is that an unhappy shareholder will not be equally forgiving of noncompliance with the registration requirements of section 8 and transaction prohibitions of section 7 and that he will bring a private action.⁵⁶

Second, if the problem that caused the large portfolio of investment securities is of a longer duration, counsel for the company may choose to file an application seeking an exemptive order from the Commission under section 3(b)(2), section 6(c), or both.⁵⁷ One disadvantage of this route is the amount of time it may take to receive an order, and the risk that someone will

gaged" test of § 3(a)(1) and the 40%-of-assets test of § 3(a)(3), it will not recommend that the Commission take any action under the Investment Company Act against a tax shelter issuer if, at the end of six months from the completion of its offering, the issuer will have committed or have binding or specific bona fide plans to commit more than 50% of its assets to operating projects, such that the tax shelter would satisfy the conditions for an order under § 3(b)(2) or the conditions of an exclusion in § 3(c). *E.g.*, Lund, Levin & O'Brien (SEC staff letter, July 19, 1974) (concerning Hanover Planning Co.).

Counsel may be able to give his opinion that, despite the apparent applicability of § 3(a)(3), the company is excluded from the definition of investment company by § 3(b)(1), § 3(b)(3), or one of the paragraphs of § 3(c). Section 3(b) excludes, notwithstanding § 3(a)(3),

(1) Any issuer primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities. . . .

. . . .[and]

(3) Any issuer all the outstanding securities of which (other than short-term paper and directors' qualifying shares) are directly or indirectly owned by a company excepted from the definition of investment company by paragraph (1) or (2) of this subsection.

Because these paragraphs are self-operating, while § 3(b)(2) requires submission of an application requesting a Commission order, the Commission staff under most circumstances will decline to take a no-action position as to the applicability of either paragraph to a particular company.

⁵⁶ See *Cogan v. Johnston*, 162 F. Supp. 907 (S.D.N.Y. 1958) (denial of motion to dismiss action by shareholder against company directors to enjoin violations of the Act and to provide other relief). The most accessible remedy against the unregistered company, it has been argued, is rescission of the company's contracts under § 47(b). Nielson, *Neglected Alternatives for Investor Self-Help: The Unregistered Investment Company and the Federal Corporate Law*, 44 NOTRE DAME LAW. 699 (1969). For an extended discussion of problems encountered in reorganizations of unregistered investment companies, see Kerr & Appelbaum, *supra* note 9, at 899-905. Under § 42(e), the Commission may seek the extraordinary remedy of appointment of a trustee in an injunctive action against a person who has engaged or is about to engage in any act or practice constituting a violation of the Investment Company Act or rules thereunder. This remedy is available against unregistered companies. An injunction and a trustee were obtained in, for instance, *SEC v. Fifth Ave. Coach Lines, Inc.*, 435 F.2d 510 (2d Cir. 1970), discussed at note 52 *supra*. Both the district court and court of appeals were prepared to find an unregistered company to have violated sections of the Act that in the words of the Act apply only to "registered" investment companies where the company was improperly not registered when the proscribed activities occurred. Compare Kerr, *supra* note 9, at 36, with Kerr & Appelbaum, *supra* note 9, at 891-92.

⁵⁷ Kerr, *supra* note 9, at 45-63 (§ 3(b)(2) applications), 63 (§ 6(c)); Kerr & Appel-

contest granting the order before the Commission or in the courts.⁵⁸

Finally, if it is not possible for the company to obtain an exemptive order under sections 3(b)(2) or 6(c), counsel would have to register the company pursuant to section 8.⁵⁹ To terminate registration he may later file with the Commission applications for orders under section 6(c), section 8(f), or both. As one commentator has noted, "the company, by registering, will become subject to an act that bows to none in the detail of its regulation. In continuing to carry on its operating business, such a company would find itself subject to regulations that do not reach its competitors."⁶⁰ It should not be forgotten, however, that the company's "assets" have become vulnerable to substantial abuse. The company has become something, no matter how inadvertently or unintentionally, that the Investment Company Act was intended to regulate.

We recommend several changes to clarify the scope of section 3(a)(3) and the availability of certain exclusions and exemptions. Despite our attempts to foresee problems caused by different suggestions, it is impossible to be certain that all implications of each change have been anticipated. These recommended changes, then, must be viewed as tentative proposals.

baum, *supra* note 9, at 889-92. Filing an application in good faith under § 3(b)(2) gives a company 60 days of automatic exemption from the entire Investment Company Act, which may be extended upon cause shown.

A company unable to meet the tests for exemption under § 3(b)(2) may nevertheless believe it can convince the Commission to exercise its broad discretionary power under § 6(c) to grant exemptions "necessary or appropriate in the public interest and consistent with the protection of investors" Indeed, if the company is an investment company within the meaning of § 3(a)(1) because it is "primarily engaged" in investment company activities, the company's only avenue for an exemptive order may be § 6(c). Section 3(b)(2) speaks in terms of "primarily engaged" and it would not be possible for a company simultaneously to be "primarily engaged" both in investment company and industrial or other non-investment company activities. We disagree with Kerr's analysis to the contrary. See Kerr, *supra* note 9, at 67-69.

On the other hand, Kerr is quite correct in stating that the two most important factors in a § 3(b)(2) application are the ratios of investment securities to total assets and of investment security income to operating revenues. *Id.* 67-69. The Commission staff has taken the position that, if these two factors are substantially negative, satisfaction of the other tests enunciated in *Tonopah Mining Co.*, 26 S.E.C. 426 (1947), is of no help. Cf. *Electric Bond & Share Co.*, SEC Investment Company Act Release No. 4590 (May 10, 1966).

⁵⁸ Cf. *Christiana Securities Co.*, SEC Investment Company Act Release No. 8615, 5 SEC DOCKET 745 (Dec. 13, 1974), *rehearing denied*, Investment Company Act Release No. 8692, 6 SEC DOCKET 366 (Feb. 27, 1975).

⁵⁹ See rules 0-2 to 0-8, 8b-1 to 8b-32, 17 C.F.R. §§ 270.0-2 to 0-8, 8b-1 to 8b-32 (1975).

⁶⁰ Kerr, *supra* note 9, at 30-31.

(ii) Recommended Changes in Section 3(a)(3)

First, section 3(a)(3)'s test of whether forty percent of a company's total assets are in investment securities is applied to the balance sheet on an unconsolidated basis. A company's interest in its wholly-owned subsidiaries,⁶¹ which would be included in the non-investment security assets, is therefore entered on the balance sheet at historical cost or in an amount equal to the net assets of the subsidiaries.⁶² That entry may distort the relative value to the company of its investment securities and its other assets. A parent holding company that has extensive industrial operations through wholly-owned subsidiaries is still not able to consolidate its assets with industrial assets of its wholly-owned subsidiaries in making the section 3(a)(3) calculations. If it has a relatively large portfolio of investment securities in comparison with its own assets, the company may then be described by section 3(a)(3). Such a company may be unwilling to risk potential shareholder suits by relying on an opinion of its counsel that it satisfies the conditions for exclusion in section 3(b)(1), may not be able to get no-action assurance from the Commission staff, and thus may feel forced to file an application under section 3(b)(2) seeking a Commission order of exemption.

To avoid this problem, we believe section 3(a)(3) should be amended to require a company to consolidate its total assets with those of its wholly-owned subsidiaries for purposes of calculations under section 3(a)(3). Generally speaking, under state law a parent company's responsibilities in dealing with its wholly owned subsidiary do not appear to be materially different from its responsibilities with respect to an unincorporated division of the company.⁶³ In the case of majority-owned subsidiaries,

⁶¹ "Wholly-owned subsidiary" is defined in § 2(a)(43).

⁶² Such assets could be valued for § 3 purposes at more (or less) than historical cost, as determined in good faith by the board of directors. See § 2(a)(41)(A)(ii). L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE ch. 15 (3d ed. 1972).

⁶³ This similarity is most apparent under the "short-form merger" statutes that permit a parent company to merge with its wholly owned subsidiary without receiving stockholder approval from either corporation. The usual shareholder appraisal rights, however, would run to the wholly owned subsidiary's minority shareholders. V. BRUDNEY & M. CHIRELSTEIN, CORPORATE FINANCE 614-21 (1972); W. CARY, CASES AND MATERIALS ON CORPORATIONS 1712-14 (4th ed. unabridged 1969); Comment, *The Short Merger Statute*, 32 U. CHI. L. REV. 596 (1965). Courts in Delaware and New York have held appraisal rights resulting in cash payments to be the exclusive remedy of a minority shareholder of a wholly owned subsidiary in a short-form merger. See, e.g., *Stauffer v. Standard Brands, Inc.*, 41 Del. Ch. 7, 187 A.2d 78 (Sup. Ct. 1962); *Beloff v. Consolidated Edison Co.*, 300 N.Y. 11, 87 N.E.2d 561 (1949); Vorenberg, *Exclusiveness of the Dissenting*

where the relationship between parent and subsidiary is materially less close as a matter of state law, the present scheme of using an unconsolidated basis should and would remain untouched. Thus the recommended change would eliminate a distortion of measurement due only to the form and not the substance of certain parent-subsidiary relationships; it would not do violence to the legislative purpose behind section 3(a)(3).⁶⁴ The change would give a parent company greater assurance, without incurring the expense of seeking an exemptive order, that it is protected from shareholder suits to enforce the Investment Company Act.

Second, by its terms section 3(a)(3) applies, and the registration and regulatory provisions of the Investment Company Act are triggered, if a company satisfies the statutory conditions at any moment in time. A company may be subject to significant penalties for its failure to register promptly⁶⁵ even if its portfolio of investment securities is inadvertently and unusually large for just a short period of time. The six-month no-action position taken by the Commission staff in the context of "start-up" companies and in other situations⁶⁶ is not a complete answer for such companies because shareholders may nonetheless sue the company for its lack of compliance. Thus, we believe section 3(a)(3) should be amended so as not to apply to a company that has met the substantive conditions of the section for less than six months during any twenty-four month period, if throughout the six months the company has made commitments or has made bona fide plans to commit more than sixty percent of its total assets to assets that are not "investment securities."⁶⁷

Stockholder's Appraisal Right, 77 HARV. L. REV. 1189 (1964). But see Brudney & Chirelstein, *Fair Shares in Corporate Mergers and Takeovers*, 88 HARV. L. REV. 297 (1974) (sharing formula necessary to provide fair treatment of gains realized by all parties to short merger). See also *Sinclair Oil Corp. v. Levien*, 280 A.2d 717 (Del. Sup. Ct. 1971) (parent permitted to force 97%-owned subsidiary to pay out dividends in excess of earnings even though result was to deny subsidiary any independent opportunity for development).

⁶⁴ For a discussion of the legislative history of § 3(a)(3), see Kerr, *supra* note 9, at 32-35. Kerr had access to the personal files of the SEC staff member most closely associated with the 1940 legislation that became the Investment Company Act. He concludes that the intent of § 3(a)(3) was not to cover companies that were essentially industrial companies operating through wholly owned subsidiaries. *Id.* 45-48, 68.

⁶⁵ See §§ 44, 47(b), 49; note 56 *supra*.

⁶⁶ See note 55 *supra* & accompanying text.

⁶⁷ A company that would find itself within § 3(a)(3), amended in the manner we have suggested, for a six-month period in two or more consecutive twenty-four month periods would, of course, also raise serious questions as to whether the activities in which it was primarily engaged would not render it an investment company under § 3(a)(1).

We also recommend changing the constituents of the assets ratio⁶⁸ in section 3(a)(3) in order to avoid unnecessary distortions of investment choices. We are aware that many companies may place assets in government securities or cash solely to avoid classification as an investment company under the section 3(a)(3) test.⁶⁹ Of course, these companies cannot so easily escape the rigors of section 3(a)(1).⁷⁰ Distortions may nonetheless occur.

One approach to the problem would be to reinsert government securities in both the numerator and denominator of the

A company in a transitional state may also find itself an investment company under § 3(a)(1). *See* note 52 *supra*. To avoid imposing undue burdens on such a company, a similar grace period also should be added to § 3(a)(1). This grace, it must be emphasized, should be contingent on the temporary nature of the condition *and* on the good faith of the company, so that it could not be applied to a company that holds itself out as or proposes to be an investment company. Such an application would be contrary to the element of good faith and would unnecessarily give a true investment company an unregulated start-up period.

⁶⁸ The Commission staff originally drafted § 3(a)(3) so that it would (or would not) apply to certain industrial companies based on their 1939-1940 balance sheets. *See* note 64 *supra*. One can, of course, question whether their 40% test, embodied in § 3(a)(3) and based on 1939-1940 facts, is responsive to today's balance sheets. Careful financial analysis, beyond the scope of this Article, is necessary to determine whether a 40% test is still an appropriate measure.

⁶⁹ For a company near the 40% line, shifting assets between cash and government securities would have no effect, making either of those investments preferable in those circumstances to investment securities, even though the rate of return on the government securities may be much worse. Shifting assets from investment securities to government securities, however, would tend to reduce the ratio, because government securities are presently excluded from both the numerator and the denominator of the § 3(a)(3) equation, although not as much as would shifting to non-cash, non-government securities. Conversely, where a company has investment securities, going from operating assets (those that are not cash or investment or government securities) to government securities would tend to increase the percentage of investment securities held as compared to total assets, but the increment would not be as great as it would be if the shift were directly to investment securities. Company management will, of course, be required under state law to invest the assets entrusted to it in a manner that will produce a competitive return. Thus, where given the choice between government and investment securities, the company on the line would exhibit a strong preference for government securities. And given the choice between government securities and operating assets, it may have a preference for operating assets. Were it not for the need to avoid application of § 3(a)(3), a company that behaved in such a manner would certainly risk a powerful suit by shareholders alleging breach of the duty to obtain a competitive return on the company's assets. It is surely poor public policy to force or encourage companies to consider and make investment decisions which are not in the best economic interests of their shareholders.

⁷⁰ Section 3(a)(1) applies to those companies that are engaged primarily in investing, reinvesting, or trading in securities, not merely "investment securities." *See* note 7 *supra* & accompanying text. Section 3(a)(1), however, may not clearly apply to a company that combines its substantial investing or trading activities in government securities with substantial operating functions; such a company may argue that maintaining a very large portfolio of government securities does not make it a company whose primary purpose is actively to trade in securities.

section 3(a)(3) fraction—that is, to end the exclusion of government securities from the definition of investment securities and total assets—and also to reinsert cash in the denominator to end the exclusion of cash and government securities from total assets. This change would appear to be the least distorting in terms of a company's decision to invest in investment securities, government securities or other assets. But such an amendment seems to go too far. Government securities do provide a profitable investment and a safe haven for the funds of a company that must be highly liquid, but which does not otherwise have the usual characteristics that should lead to registration and regulation as an investment company.⁷¹ A company with high cash demands should not be forced to forego completely the advantages of income from government securities. Such a company, however, would not be exempt from section 3(a)(3) as we would modify it, because the company would surely be in and out of its cash/government-securities position frequently during a period of more than six months during every twenty-four-month cycle. Therefore a company's only escape from section 3(a)(3) would be the exclusion of government securities from investment securities.

We propose to end only the subtraction of government securities and cash from total assets; the definition of investment securities would continue to exclude government securities. Some may suggest that this formulation is even more distorting than is the present test: A switch from investment securities to government securities would produce a larger change in percentage under our formula than under the present one. On the other hand our formula would introduce a sense of reality into the computations and decisionmaking based on those computations. The highly liquid, but non-investment company should not be pushed into section 3(a)(3) status because of a relatively small holding of investment securities. Management should be free to maximize its income, within the forty percent limit, with-

⁷¹ The apparent intent of the draftsmen of § 3(a)(3) was to permit an industrial company to place certain of its current assets into cash (or assets readily reducible into cash) or government securities; such investments were presumably considered appropriate methods for a corporation to employ in making the best short-term use of its surplus working capital. The formula in § 3(a)(3), however, does not stipulate that a company's investments in government securities and cash be of short-term duration in fact.

out fear that temporary or brief, recurring surges in liquidity would turn the corporation into an investment company.

(iii) Recommended Change in Section 3(b)

The introductory words to section 3(b)⁷² have generated confusion as to whether that section's exceptions are available only to companies that would otherwise qualify as investment companies under section 3(a)(3). Where sections 3(b)(1) and 3(b)(2) apply, the confusion has no import: Any company that qualifies for these exceptions would not be an investment company under section 3(a)(1) in the first place.

The true problem resides in section 3(b)(3), which excepts an issuer all of whose outstanding securities (other than short term notes and qualifying shares of a director) are held by a company that is excepted by sections 3(b)(1) or 3(b)(2). Surely the exception should apply only to a company whose parent is not primarily engaged in investing, reinvesting, owning, holding or trading in securities either directly or through its subsidiaries. The question is why should the exception apply only to a company whose parent owns or proposes to acquire investment securities having a value in excess of forty percent of the parent's total assets. The result would be this limited if the parent had to be excepted under sections 3(b)(1) or 3(b)(2) and to be so excepted would also have to be a company described in section 3(a)(3).

We believe section 3(b)(3) should be amended to eliminate this confusion. The parent should be one that is *described* in section 3(b)(1) or 3(b)(2), but need not be one that is *excepted* from section 3(a)(3) by those paragraphs.

Also, section 3(b) as presently worded creates difficulties for the subsidiary that qualifies as a section 3(a)(1) company yet is only the incorporated investment division of a company described in sections 3(b)(1) or 3(b)(2). This subsidiary too should have an exception under section 3(b)(3). We urge that section 3(b)(3) clearly be made an exception for wholly-owned subsidiaries that are section 3(a)(1) as well as section 3(a)(3) companies.⁷³

⁷² "Notwithstanding paragraph (3) of subsection (a) of this section, none of the following persons is an investment company within the meaning of this title" (emphasis supplied).

⁷³ Kerr, *supra* note 9, at 66. Even if the wholly-owned subsidiary is merely an incorporated investment portfolio primarily engaged in investing in securities such that it

(iv) Recommended Changes in Section 3(c)(1)

A company that has qualified as an investment company may be able to satisfy the conditions in one of the paragraphs in section 3(c) and thus be excluded from the scope of section 3(a). Section 3(c)(1) excludes any issuer the outstanding securities of which (other than short-term paper) are beneficially owned by not more than 100 persons and which is not making or proposing to make a public offering of its securities. Beneficial ownership by a company is deemed to be beneficial ownership by one person if the company owns less than ten percent of the issuer's outstanding voting securities.⁷⁴ If the company owns ten percent or more, beneficial ownership is attributed to the holders of the company's outstanding securities other than short-term paper. This pass-through is called the attribution rule.

Section 3(c)(1) presents several problems. It may be argued that a parent company owning interests in an investment company established in the form of a limited partnership would not be subject to the attribution rule in section 3(c)(1) even if the parent held more than twenty percent of the limited partnership interests. Limited partnership interests would usually not be voting securities, yet a substantial economic interest may give the holder the functional equivalent of a voting security.⁷⁵ This anomaly, unexplained in the legislative history of the Investment Company Act, is probably due to the recency of widespread use of limited partnerships as a medium for investing in securities. Because the exclusion is presumably bottomed on the lack of public interest in investment vehicles with not more than one hundred beneficial owners and because the limited partnership

would be an investment company within the meaning of § 3(a)(1), in addition to § 3(a)(3), it may still be able to rely on § 3(b)(3). It would also be a § 3(a)(3) company and § 3(b) provides exclusions from § 3(a)(3). See Kerr, *supra* note 9, at 66-69. If the value of the assets of the wholly-owned subsidiary constituted 40% or more of the assets of the parent, the parent would be a § 3(a)(3) company and the parent's status, and thus that also of the subsidiary, would then depend on the availability to the parent of the exclusions in §§ 3(b)(1) and 3(b)(2).

⁷⁴ "Voting security" is defined in § 2(a)(42) as any security entitling the owner or holder to vote for the election of directors of the company.

⁷⁵ The Commission staff has taken the position that where ownership of limited partnership interests exceeds 20% of the equity capital in the limited partnership, such ownership constitutes the equivalent of greater than 10% of the voting securities. The owner, the staff reasoned, could be expected to have an ability to exercise control through economic power. The limited partnership interests, notwithstanding the absence of a specific right to elect directors, were therefore functionally equivalent to voting securities. On the last point, see, e.g., Drinker, Biddle & Reath (SEC staff letter, May 10, 1973) (concerning INA Trading Corp.).

device permits much broader ownership, the treatment of limited partnerships in section 3(c)(1) should be made consistent with the section's treatment of other types of companies. The term "voting" should be deleted.⁷⁶

Section 3(c)(1)'s attribution rule has been modified in the context of small business investment companies (SBICs). In rule 3c-2(a),⁷⁷ the Commission deems a company's beneficial ownership of ten percent or more of the outstanding voting securities of an SBIC licensed to operate by the Small Business Administration to be beneficial ownership by one person under certain circumstances. Those circumstances are that the value of all securities of all SBICs in the portfolio of the company holding the beneficial interest does not exceed five percent of the value of the total assets of that company.⁷⁸ Although the Commission presently has sufficient authority under section 6(c) to adopt such an exemptive rule of general applicability, it would seem more appropriate simply to codify rule 3c-2.

The newly codified rule should also be made applicable to all investment companies whose shares are held by industrial companies and whose shares and those of all other investment companies constitute five percent or less of the assets of each of those industrial companies. This broadened exception would allow industrial firms to put limited amounts of their cash into funds specializing in money market instruments without subjecting the funds to investment company regulation. The fund would enable the firms to obtain greater diversity in investing their excess cash than each could manage individually. This

⁷⁶ One minor problem caused by this change would be the calculation of the percentages of outstanding securities if the securities issued are in several different classes, or if both debt and equity securities are outstanding. This problem could be left to and resolved by Commission rulemaking.

⁷⁷ Rule 3c-2(a), 17 C.F.R. § 270.3c-2(a) (1975). For a thorough discussion of the interaction of small business investment companies and the Investment Company Act, see Mendelsohn & Cerino, *Application of the Federal Securities Laws to Minority Enterprise Small Business Investment Companies "Mesbics,"* 16 HOWARD L.J. 744 (1971). Many SBICs are established in a manner that satisfies the conditions of rule 3c-2, thereby obviating the need for filing registration statements under the Investment Company Act and under the Securities Act of 1933. Mendelsohn & Cerino, *supra*, 749-51. Under Securities Act of 1933 regulation E, moreover, a form for "notification" filing and a schedule for the offering circular are provided for SBICs. 17 C.F.R. §§ 230.601-610 (1975).

⁷⁸ Rule 3c-2 was adopted to effectuate the purposes and objectives of the Small Business Investment Act, 15 U.S.C. §§ 661-96 (1970). SEC Investment Company Act Release Nos. 5452, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,582 (Aug. 5, 1968); 2909, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,664 (Sept. 4, 1959).

would be consistent with the policy of section 3(c)(1) to regulate purportedly private investment companies which are used as indirect media for investment by the public. Where the industrial company's investment in securities through ownership of interests in an investment company constitutes a relatively minor part of the industrial company's assets, the need for Investment Company Act regulation of the investment company is minimized.

Section 3(c)(1) also limits the issuance of debt securities to short-term paper by requiring that the holders of all other types of debt securities be counted toward the ceiling of 100 beneficial owners.⁷⁹ If the company relying on section 3(c)(1) can otherwise meet the conditions of the section, no public policy reasons appear for limiting its leverage opportunities to short-term paper. The financing of the leveraging should be limited to investors who have the ability and resources to monitor their investments without a sweeping regulatory overlay. Thus, the short-term paper exception of section 3(c)(1) should be amended to include also debt securities held by institutional investors.⁸⁰

(v) Recommended Change in Section 3(c)(6)

A parent company operating through subsidiaries may also find its way out of section 3(a) through section 3(c)(6). That paragraph excludes any company primarily engaged, directly or through majority-owned subsidiaries, in one or more of the businesses⁸¹ described in paragraphs (3) (banking, insurance,

⁷⁹ Rule 3c-3, 17 C.F.R. § 270.3c-3 (1975), excludes the offer and sale of debt securities by SBICs (typically to large institutional investors) from the term "public offering" as used in § 3(c)(1) if the debt securities are not convertible into equity securities and are guaranteed as to timely payment of principal and interest by the Small Business Administration. Rule 3c-3 also counts the holders of these debt securities collectively as one person for purposes of the 100-beneficial-owners condition. Rule 3c-3 should be modified to mesh with the changes to § 3(c)(1) recommended at text accompanying note 80 *infra*.

⁸⁰ "Institutional investor" is defined in ALI FED. SEC. CODE § 242 (Rev. Tent. Draft Nos. 1-3, 1974). A similar change should also be made to § 3(b)(3). See notes 72-73 *supra*.

⁸¹ It is not clear from the legislative history of the Investment Company Act why broker-dealers, excluded by § 3(c)(2), were not included in § 3(c)(6). Perhaps broker-dealers, traditionally organized as partnerships, were not thought of as possible parents or subsidiaries. In recent years, however, the broker-dealer industry has tended to move away from the partnership form to public ownership in corporate form, and, most recently, to formation of a parent holding company with separately incorporated subsidiaries for broker-dealer and other activities. See Augsburger, *Broker-Dealers Going Public*, in *NEW TRENDS AND SPECIAL PROBLEMS UNDER THE SECURITIES LAW* 31 (A. Sommer Jr. & H. Enberg eds. 1970); Wall St. J., May 2, 1975, at 20, col. 3; *id.*, April 19, 1973, at 12, col. 3; *id.*, Mar. 15, 1973, at 7, col. 1; *id.*, Dec. 19, 1972, at 1, col. 6; N.Y. Times, Oct.

savings and loan), (4) (small loans), and (5) (commercial financing, mortgage banking and real estate), "or in one or more of such businesses (from which not less than 25 per centum of such company's gross income during its last fiscal year was derived) together with an additional business or businesses other than investing" Section 3(c)(6) thus focuses on the parent holding company's gross income, but the statute is silent as to whether the twenty-five percent test is applied on a consolidated or unconsolidated basis. It would seem appropriate that the ALI Code resolve this ambiguity. We recommend that gross income of the parent holding company be computed in a manner consistent with section 3(a)(3)—that is, on a consolidated basis as to wholly-owned subsidiaries and on an unconsolidated basis as to majority-owned subsidiaries that are not investment companies.

b. *Definition of "Insurance Company"*

Investment Company Act section 2(a)(17) and ALI Code section 244⁸² define the term "insurance company" in materially different ways. Section 2(a)(17) defines an insurance company, *inter alia*, as "a company which is organized as an insurance company, whose *primary and predominant* business activity is the writing of insurance"⁸³ ALI Code section 244 defines an insurance company as "a company doing business under the laws of a State if (1) a *substantial portion* of its business consists of the writing of insurance or annuity contracts"⁸⁴ The Reporter's Note⁸⁵ states that the definition was "redrafted in the interest of furthering stylistic consistency," and to conform to the definition of "bank" in ALI Code section 209(c)(1),⁸⁶ although the Note does concede that the changes in section 244 are substantive and *will*⁸⁷ enlarge the exclusion for insurance companies provided by section 3(c)(3). Assuming *arguendo* that a good purpose would be served by standardizing the style of definitions used in the ALI Code, it nevertheless seems inappropriate in a codification effort

10, 1971, § F, at 2, col. 1; *id.*, Sept. 12, 1971, § F, at 2, col. 1. This trend should be recognized by amending § 3(c)(6) to refer also to holding companies engaged in broker-dealer activities described in paragraph (2).

⁸² ALI FED. SEC. CODE § 244 (Rev. Tent. Draft Nos. 1-3, 1974).

⁸³ Section 2(a)(17) (emphasis supplied).

⁸⁴ ALI FED. SEC. CODE § 244 (Rev. Tent. Draft Nos. 1-3, 1974) (emphasis supplied).

⁸⁵ *Id.* Reporter's Note.

⁸⁶ *Id.* § 209(c)(1). For a discussion of the problems with the definition of "bank," see notes 110-12 *infra* & accompanying text.

⁸⁷ *Id.* § 244, Reporter's Note.

to enlarge an important exclusion from the federal securities laws without stating clearly the effects such an enlargement would have on investor protection. The Reporter's Note, moreover, leaves one little comfort (but some astonishment) as to the potential scope of the enlargement by suggesting that

it may be doubted whether the state insurance authorities will permit insurance companies to engage in mutual fund or other non-insurance activities (otherwise than through subsidiaries) to the same extent as the banking authorities have already permitted banks to engage in activities that are not of an orthodox banking character.⁸⁸

(i) Parity with Banks

Material differences between the banking and insurance industries and their regulation justify the pattern of differing substantive conditions presently found in their respective definitions. First, banks generally are regulated at the federal level by a tripartite arrangement involving the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.⁸⁹ When Congress determines to limit bank activities,⁹⁰ or to expand them,⁹¹ communication and legislation can take effect directly at the federal level. Insurance companies, on the other hand, are not subject to federal supervision, ex-

⁸⁸ *Id.*

⁸⁹ 2 IIS REPORT, *supra* note 18, at 413 n.2, 442-43. See generally Randall, *The Federal Deposit Insurance Corporation: Regulatory Functions and Philosophy*, 31 LAW & CONTEMP. PROB. 696 (1966); Robertson, *Federal Regulation of Banking: A Plea for Unification*, 31 LAW & CONTEMP. PROB. 673 (1966).

⁹⁰ See, e.g., Banking Act of 1933, ch. 89, 48 Stat. 162, as amended (codified in scattered sections of 12 U.S.C.). The scope of the Glass-Steagall Act as applied to commingled managing agency accounts was determined in *Investment Co. Institute v. Camp*, 401 U.S. 617 (1971). The Investment Company Institute and the New York Stock Exchange have begun litigation against the Comptroller of the Currency claiming "automatic investment services" violate the Glass-Steagall Act. *New York Stock Exch., Inc. v. Smith*, [Current] CCH FED. SEC. L. REP. ¶ 95,370 (D.D.C., Dec. 5, 1975). The Investment Company Institute recently lost litigation against the Federal Reserve Board, claiming the Board's regulation Y regarding closed-end investment companies also violates the Act. *Investment Co. Institute v. Board of Governors of the Fed. Reserve Sys.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,540 (D.D.C., filed May 8, 1974).

⁹¹ See, e.g., Bank Holding Company Amendments of 1970, Pub. L. No. 91-607, 84 Stat. 1760 (codified in scattered sections of 12, 31 U.S.C.). For an excellent treatise on the legislative history of the amendments and subsequent interpretations by the Federal Reserve Board, see C. BLAINE, *FEDERAL REGULATION OF BANK HOLDING COMPANIES* (1973).

amination, or regulation.⁹² Second, although both bank and insurance company regulators are concerned primarily with the solvency of their financial institutions, bank regulators also examine, supervise, and promulgate rules for the fiduciary activities of banks.⁹³ Insurance company regulators, on the other hand, are almost exclusively concerned with financial solvency and give regulation of fiduciary activities cursory oversight at best.⁹⁴ Thus, assuming the reason bank securities activities were excluded from certain provisions of the federal securities laws is the existence of adequate analogous regulation at the federal level,⁹⁵ that reason does not extend to insurance company securities activities.

⁹² McCarran-Ferguson Act, 15 U.S.C. §§ 1011-15 (1970). See 2 IIS REPORT, *supra* note 18, at 865-66; Frankel, *Regulation of Variable Life Insurance*, 48 NOTRE DAME LAW. 1017, 1045-82 (1973) [hereinafter cited as Frankel I]; Frankel, *Variable Annuities, Variable Insurance, and Separate Accounts*, 51 B.U.L. REV. 173, 209-11 (1971) [hereinafter cited as Frankel II].

⁹³ The Comptroller of the Currency's Regulation 9, 12 C.F.R. § 9 (1975), is the principal federal fiduciary regulatory scheme. See C. GOLEMBE ASSOC., INC., *THE ECONOMIC POWER OF COMMERCIAL BANKS* 56 (1969). For discussions of bank trust department examinations and supervision, see *id.* 55-64; E. NEILAN, *TRUST EXAMINATION: AN EXAMINER'S ANALYSIS* (1939); Miller, *Regulation of Fiduciaries*, in AMER. BANKERS ASS'N, *PROCEEDINGS, FIDUCIARY RESPONSIBILITY SEMINAR* 56 (1970); see note 95 *infra*.

⁹⁴ 2 IIS REPORT, *supra* note 18, at 865:

The primary objective of State regulation is protection of policyholders, although revenue production through taxation is also a major consideration. Toward these objectives State regulation enters all phases of the insurance business including restricting investment, conducting periodic financial examinations, approving policies and rates and licensing companies, agents, and brokers.

See Frankel II, *supra* note 92, at 212: "State regulation is, therefore, aimed at protecting creditors who have no voice in management and are mostly interested in the security of the funds and the soundness of the business of their debtor." See also Frankel I, *supra* note 92, at 1066-82 (analysis of areas in which the federal securities laws can add investor protections to the debtor/creditor protections provided under state law).

⁹⁵ In April, 1974, the Commission announced an inquiry into bank-sponsored investment services. SEC Securities Act Release No. 5491, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,767 (April 30, 1974). SEC Commissioner Evans has indicated, in commenting upon the decision to begin an inquiry, that the Commission is caught in "a rather serious dilemma . . . in fulfilling its responsibilities [in view of] what some believe to be blanket exemptions for banks from various provisions of the securities laws." Address by SEC Commissioner Evans, Ninth Annual Banking Law Institute, New York City, May 2, 1974, at 3, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,775, at 84,102. Commissioner Evans further commented:

[W]hether Congress provided such exemptions because banks were already regulated by bank agencies or whether such exemptions were provided because banks were not expected to engage in securities activities to a significant degree or whether such exemptions were simply a result of bank political power is not completely clear . . .

Id. In this important speech, Commissioner Evans stated several alternative theories and strategies the SEC could follow if, based on its analysis of the public comments received in response to its inquiry, it determined that the lack of investor protection under the

(ii) Types of Insurance Activities Permitted

In suggesting that state regulators will permit only a narrow range of activities by insurance companies, the Reporter's Note ignores extensive litigation over the status of variable annuity contracts under the federal securities laws⁹⁶ and the Commission's present involvement with regulation of the issuers⁹⁷ of variable life insurance contracts under the Investment

banking laws required the Commission to assert jurisdiction and to regulate directly bank-sponsored investment services. See Evans, *Regulation of Bank Securities Activities*, 91 BANKING L.J. 611 (1974). For an analysis of the adequacy of the regulation of bank trust department investment activities compared with the regulation of persons in the securities industry offering similar services, see Lybecker, *Regulation of Bank Trust Department Investment Activities*, 82 YALE L.J. 977 (1973); Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps and Eight Remedies* (pts. 1-2), 90 BANKING L.J. 912 (1973), 91 *id.* 6 (1974).

⁹⁶ In SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65 (1959), the Supreme Court held that, for purposes of the federal securities laws, variable annuity contracts are securities, not insurance contracts, and are therefore subject to the registration provisions of the Securities Act of 1933. Since VALIC intended to engage predominantly in issuing variable annuity contracts, which the Supreme Court held were securities, it could not satisfy § 2(a)(17) and thus could not rely on § 3(c)(3) of the Investment Company Act, and it had to register. In Prudential Ins. Co. of America v. SEC, 326 F.2d 383 (3d Cir.), *cert. denied*, 377 U.S. 953 (1964), the Third Circuit held that the issuer of proposed annuity contracts was the separate account established by the insurance company to fund the liability, not Prudential whose predominant business was the writing of conventional insurance contracts. (It could be argued that the Third Circuit found that Prudential was a co-issuer.) Thus, the separate account, whose sole business would be the issuance of variable annuity contracts, would also be required to register. See Frankel II, *supra* note 92, at 195-216, 231-34. See also SEC v. United Benefit Life Ins. Co., 387 U.S. 202 (1967).

⁹⁷ Because the issuer of the variable annuity and variable life insurance contracts is the separate account formed by an insurance company to fund the liabilities, see note 96 *supra*, the definition of "separate account" is important. The definitions of "separate account" in the Investment Company Act, § 2(a)(37), and in the ALI Code, ALI Fed. Sec. CODE § 298 (Rev. Tent. Draft Nos. 1-3, 1974), are virtually identical except for stylistic changes. We believe, however, that it would be desirable to insert a clause that would require the separate account to be legally segregated, to be exempt from claims arising out of any other business of the insurance company, and to have assets with a value at least equal to the reserves and other liabilities with respect to the account. See rule 0-1(e)(2), 17 C.F.R. § 270.0-1(e)(2) (1975). The need for such a clause is articulated in SEC Investment Company Act Release No. 5741 [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,730 (July 15, 1969) (adoption of rule 6e-1 relating to separate accounts used to fund qualified pension and profit-sharing plans). Many state laws that authorize the establishment of separate accounts by insurance companies either require or permit segregation through addition of appropriate provisions in the participation contracts. Some states do not require or permit such segregation. In such states, the insurance company could make other arrangements, perhaps through insurance with another company, to protect creditors in the event of the insurance company's insolvency. See generally Frankel I, *supra* note 92, at 1041-82. Rule 6e-1 was rescinded by the Commission, SEC Investment Company Act Release No. 6430, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,019 (April 2, 1971), because the Investment Company Amendments Act of 1970 amended § 3(c)(11) to exclude from the definition of invest-

Company Act.⁹⁸ After extensive public hearings during 1972,⁹⁹ the Commission determined that the issuance of variable life insurance contracts involved the offer and sale of a separate security by an investment company.¹⁰⁰ The Commission initially exempted the separate accounts used to fund certain variable life insurance contracts from the registration and other provisions of the Investment Company and Investment Advisers Acts by adopting the now-rescinded rules 3c-4 and 202-1.¹⁰¹ Rule 3c-4 defined "insurance company" as used in section 3(c)(3) of the Investment Company Act to include a separate account funding certain variable life insurance contracts.

In adopting rules 3c-4 and 202-1, the Commission tried to reconcile the regulatory scheme of the Investment Company Act with the developing pattern of state insurance regulation, with emphasis on the role of the National Association of Insurance Commissioners (NAIC) and their Model Variable Life Insurance Regulations.¹⁰² The mutual fund group that had participated

ment company those separate accounts that are funded solely by contributions from qualified pension plans.

⁹⁸ See Division of Investment Management Regulation, Securities & Exchange Comm'n, *Report on Variable Life Insurance Rules*, in CCH MUTUAL FUNDS GUIDE SPEC. REP. (Feb. 5, 1973) [hereinafter cited as *VLI Staff Report*]; Blank, Keen, Payne & Miller, *Variable Life Insurance and the Federal Securities Laws*, 60 VA. L. REV. 71 (1974) [hereinafter cited as Blank]; Frankel I, *supra* note 92. See also Glenn, *New Inflation Hedges—Variable Life Insurance, Annuities Gain in Popularity*, BARRON'S, Oct. 30, 1972, at 3.

⁹⁹ *VLI Staff Report*, *supra* note 98, at 1-14; Blank, *supra* note 98, at 82-84.

¹⁰⁰ SEC Investment Company Act Release No. 7644, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,207 (Jan. 31, 1973); N.Y. Times, Feb. 1, 1973, at 1, col. 2; Wall St. J., Feb. 1, 1973, at 2, col. 2.

¹⁰¹ Rules 3c-4 & 202-1, 17 C.F.R. §§ 270.3c-4 & 275.202-1 (1975), were rescinded effective July 30, 1975. SEC Investment Company Act Release No. 8826, [Current] CCH FED. SEC. L. REP. ¶ 80,206 (June 18, 1975).

¹⁰² SEC Investment Company Act Release No. 7644, at 4-6, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,207 at 82,660 (Jan. 31, 1973):

Consistent with the representations made by the National Association of Insurance Commissioners, we expect the states to move expeditiously to develop, refine and adopt regulations with respect to variable life insurance. Further, we expect that such regulations will provide material protections to purchasers substantially equivalent to the relevant protections that would be available under the Investment Company Act. . . . The Commission will closely monitor the development of state law in this area to assure its adequacy in providing these protections and, if in the future it appears that substantial deficiencies exist and are not likely to be remedied, the Commission will then consider whether it is necessary or appropriate to modify or rescind Rule[s] 3c-4 [and 202-1].

During the initial and subsequent variable life insurance hearings and proceedings, the NAIC consistently argued that the Commission had and should have no jurisdiction over variable life insurance. Particularly in the wake of the Equity Funding collapse, however, others have criticized state regulation of insurance companies. See, e.g., Wall St. J., Aug. 2, 1973, at 1, col. 6.

in the proceedings and had opposed the exemptive rules sued the Commission over the rules it adopted.¹⁰³ After the commencement of the litigation the Commission proposed amendments to the exemptive rules.¹⁰⁴ The proposed amendments would have conditioned the availability of the two existing exemptive rules on a determination by the Commission that a particular state's law and regulations would meet certain minimum standards of investor protection substantially equivalent to relevant provisions of the two 1940 Acts. The NAIC made extensive efforts to develop model variable life insurance regulations;¹⁰⁵ public hearings were held to discuss the desirability of adopting the proposed amendments and the adequacy of investor protection provided by the NAIC's model regulations.¹⁰⁶ Despite the NAIC's efforts, the Commission determined not to adopt the proposed amendments and rescinded the exemptive rules.¹⁰⁷ In view of the uniformly unfavorable comments on the proposed amendments to the variable life insurance exemptive rules, the Commission concluded that the proposed prior approval arrangement "would not result in uniformity of regulatory oversight . . . or adequate investor protections," and that application of the Investment Company and Investment Advisers Acts was necessary to achieve investor protection.¹⁰⁸ The

¹⁰³ *Wellington Management Co. v. SEC*, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,792 (D.C. Cir. 1973) (petition for review); Wall St. J., Feb. 28, 1973, at 12, col. 2.

¹⁰⁴ SEC Investment Company Act Release No. 8000, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,518 (Sept. 20, 1973); Wall St. J., Sept. 21, 1973, at 2, col. 2. For digests of certain comments on the proposed amendments, see *Mutual Funds Group Asks SEC to Rescind Variable Life Rules*, BNA SEC. REG. & L. REP. No. 229, at A-2 (Nov. 28, 1973); *Hart, Proxmire Urge SEC to Reexamine Exemptions for Variable Life Insurance*, BNA SEC. REG. & L. REP. No. 228, at A-18 (Nov. 21, 1973).

¹⁰⁵ See, e.g., *Latest Draft of Model Variable Life Insurance Regulation Released by NAIC*, BNA SEC. REG. & L. REP. No. 229, at A-1 (Nov. 28, 1973). The October 30, 1973, draft of the NAIC Model Variable Life Insurance Regulation appears in BNA SEC. REG. & L. REP. No. 226, at E-1 (Nov. 7, 1973). Excerpts from the draft of Dec. 1, 1973, appear in BNA SEC. REG. & L. REP. No. 229, at D-1 (Nov. 28, 1973).

¹⁰⁶ SEC Investment Company Act Release No. 8216, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,632 (Jan. 31, 1974); *SEC To Hold Hearings on Variable Life Insurance Rules*, BNA SEC. REG. & L. REP. No. 238, at A-4 (Feb. 6, 1974). Two of the issues at the hearings were whether the NAIC's Model Regulations provided substantially equivalent investor protections, and, if so, how the Commission should deal with problems when different states adopt the Model Regulations with changes that would materially affect investor protections.

¹⁰⁷ SEC Investment Company Act Release No. 8826, [Current] CCH FED. SEC. L. REP. ¶ 80,206 (June 18, 1975). See also SEC Investment Company Act Release No. 8690, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,117 (Feb. 27, 1975).

¹⁰⁸ SEC Investment Company Act Release No. 8690 at 4, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,117 at 85,129-30 (Feb. 27, 1975).

Commission has announced its intention to develop by rules a pattern of appropriate limited and conditional exceptions for variable life insurance contracts under section 6(e) of the Investment Company Act.¹⁰⁹ It has not yet acted.

(iii) Conclusion and Recommendation

With all respect, this brief review of the results of the controversy over variable annuity and variable life insurance contracts confirms that state insurance authorities would permit insurance companies to engage in "mutual fund or other non-insurance activities." And they would permit it under a regulatory pattern that the Commission has found to be deficient in comparison with the investor protections provided by the 1940 Acts. Accordingly, the ALI Code definition of insurance company should require a higher degree of concentration on insurance matters—the "primarily and predominantly" standard of present law—before a company engaged to a substantial degree in the business of issuing securities, not underwriting insurance, is entitled to rely on an exclusion from the important investor protections provided by the federal securities laws.

c. Definition of "Bank"

Banks, like insurance companies, are excluded from regulation as investment companies under section 3(c)(3) even if they

¹⁰⁹ The § 6(e) rules would develop a pattern of regulation responsive to "the nature of the product, the risks assumed by the life insurer and regulatory activities of state insurance regulators." SEC Investment Company Act Release No. 8691 at 3, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,118 at 85,132 (Feb. 27, 1975). One insurance company has chosen to apply individually for what it believes are the minimum necessary exemptions, rather than wait for the Commission to adopt rules. SEC Investment Company Act Release No. 8888, 7 SEC DOCKET 588 (Aug. 13, 1975) (notice of filing of application of Equitable Variable Life Insurance Co.); *Equitable Life Assurance Society Submits First Variable Life Insurance Contract*, BNA SEC. REG. & L. REP. No. 318, at A-19 (Sept. 10, 1975). The application has been granted. SEC Investment Company Release No. 8992, 8 SEC DOCKET 185 (Oct. 16, 1975), reported in *Equitable's Application for Exemptive Order on Variable Life Product Approved*, BNA SEC. REG. & L. REP. No. 325, at A-7 (Oct. 29, 1975).

Although the Commission announced its intention to propose a tailored exemptive rule for variable life insurance under § 6(e) of the Investment Company Act, it did not propose to adopt any exemptive rules under the Investment Advisers Act. Insurance companies advising registered investment companies (*i.e.*, separate accounts funding variable annuities or variable life insurance contracts) have, however, been exempted by order from registration under the Investment Advisers Act until certain problems could be resolved relating primarily to the record-keeping rules under § 203. SEC Investment Advisers Act Release No. 308 (Feb. 10, 1972); see note 230 *infra*. For a discussion of proposed rule 202-2, SEC Investment Company Act Release No. 7565, [1972-1973

qualify under section 3(a). Section 209(c)(1) of the ALI Code¹¹⁰ would omit from the "bank" definition an important condition now contained in section 2(a)(5) of the Investment Company Act, section 202(a)(2) of the Investment Advisers Act, and section 3(a)(6) of the Securities Exchange Act.¹¹¹ That condition requires that a state-chartered bank must not have been formed for the purpose of evading the provisions of the relevant Act. The ALI Code Reporter's Note states that the "evasion" condition was deleted as "redundant, and possibly mischievous in the absence of similar clauses elsewhere."¹¹²

The current definition of "bank" is quite unusual in comparison with other definitions: A bank is not defined primarily in terms of its functions, but rather by reference to the type of agency that regulates it. The absence of a similar "evasion" condition in other analogous definitions can be explained, then, by the prevailing use of functional definitions that implicitly assume a lack of evasive purpose if the functional tests are satisfied. In such circumstances, inclusion of an evasion condition would be redundant.

No legislative history explains why, in all of the Acts, the condition applies only to state-chartered banks and certain other institutions. It can be theorized, however, that Congress omitted the no-evasion condition for national banks and member banks of the Federal Reserve System because it assumed that they would always act and be regulated as banks, or that Congress could use its authority directly to regulate their engaging in specific securities or investment activities. State-chartered banks, on the other hand, are excluded from the operation of the Acts by reference to specific types of commercial or trust activities, regulation by state or federal bank agencies, *and* a lack of purpose to evade the provisions of the three Acts. The evasion condition, it can be argued, is not "mischievous" because Congress must have believed that a bank could obtain a state charter, be lightly supervised (if at all) by state authorities, and be formed for the purpose of evading the Securities Exchange, Investment Company, or Investment Advisers Acts.

Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,146 (Feb. 21, 1973), which would require registration only of an advisory subsidiary of an insurance company, see Lybecker, *Advisers Act Proposals*, 8 REV. SEC. REG. 916, 917 (1975).

¹¹⁰ ALI FED. SEC. CODE § 209(c)(1) (Rev. Tent. Draft Nos. 1-3, 1974).

¹¹¹ 15 U.S.C. § 78c(a)(6) (1970).

¹¹² ALI FED. SEC. CODE § 209, Reporter's Note (Rev. Tent. Draft Nos. 1-3, 1974).

Because the "evasion" condition is neither redundant nor mischievous, it should not be deleted from the ALI Code definition with respect to state-chartered banks.

d. *Registration of Foreign Investment Companies*

Section 7(d) of the Investment Company Act prohibits a foreign-chartered investment company from using the means or instrumentalities of interstate commerce "to offer for sale, sell, or deliver after sale" any of its securities in connection with a public offering.¹¹³ Section 7(d), however, goes on to authorize the Commission, upon application, to permit a foreign-chartered investment company to register under the Investment Company Act and to make a public offering of its securities if the Commission finds

that, by reason of special circumstances or arrangements, it is both legally and practically feasible effectively to enforce the provisions of this subchapter against such company and that the issuance of such order is otherwise consistent with the public interest and the protection of investors.

Very few foreign-chartered investment companies have filed section 7(d) applications.¹¹⁴ For a variety of reasons, foreign-

¹¹³ Because § 7(d) focuses narrowly on use of the means or instrumentalities of interstate commerce in connection with a public offering of securities, it is basically irrelevant as a matter of statutory interpretation that an offering and any subsequent resales are limited entirely to foreign nationals. Kaye, Scholer, Fierman, Hays & Handler (SEC staff letter, June 4, 1975) (concerning American Certificates of Deposit Fund). Nevertheless, some people have apparently interpreted the words "public offering" in § 7(d) to include only an offering to U.S. citizens, 3 IIS REPORT, *supra* note 18, at 882, based on the Commission's historical restraint from requiring registration of non-investment company public offerings made outside the United States to foreign nationals under circumstances where the securities would come to rest outside the United States. SEC Securities Act Release No. 4708, 1 CCH FED. SEC. L. REP. ¶ 1361-63 (July 9, 1964). Once a foreign offering has been accomplished, however, § 7(d) would not appear to prohibit a foreign-chartered investment company from using the jurisdictional means to conduct its investment activities and related operations. See 3 IIS REPORT, *supra* note 18, at 882. For guidelines concerning the applicability of the federal securities laws to the offering of shares of registered mutual funds outside the United States, see SEC Investment Company Act Release No. 6082, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,828 (June 23, 1970); Mostoff, *Securities Regulation Aspects*, in INVESTMENT PARTNERSHIPS AND "OFFSHORE" INVESTMENT FUNDS 386-96 (1969) [hereinafter cited as PARTNERSHIPS]. See generally 3 IIS REPORT, *supra* note 18, at 879-978; Haskins, *The Offshore Hedge Fund*, 8 COLUM. J. TRANSNAT'L L. 79 (1969); Note, *Offshore Mutual Funds: Possible Solutions to a Regulatory Dilemma*, 3 LAW & POLICY INT'L BUS. 157 (1971). For a description of the rise and fall of I.O.S. and Bernard Cornfeld, the archetypical offshore fund operator, see C. RAW, B. PAGE & G. HODGSON, "DO YOU SINCERELY WANT TO BE RICH?" (1971).

¹¹⁴ As of June 1974, only eleven foreign-chartered investment companies had re-

chartered funds have generally preferred to stay offshore.¹¹⁵ A major deterrent has been the impossibility of meeting the literal requirements of section 7(d).¹¹⁶

As securities markets and investment companies have grown more international in character,¹¹⁷ foreign countries have given greater emphasis to their own schemes of securities regulation.¹¹⁸ For example, the Organization for Economic Cooperation and Development (OECD) has adopted a code of uniform regulation for investment companies.¹¹⁹ Shortly after the OECD adopted its "Standard Rules" and as a result of recommendations in its 1971 *Institutional Investor Study Report*,¹²⁰

ceived orders from the Commission. *See, e.g.*, St. John d'El Rey Mining Co., SEC Investment Company Act Release No. 7885, 2 SEC DOCKET 105 (June 29, 1973); Pan Australian Fund Ltd., SEC Investment Company Act Release No. 8028, 2 SEC DOCKET 585 (Oct. 10, 1973). Rule 7d-1, 17 C.F.R. § 270.7d-1 (1975), sets forth certain conditions, undertakings, and agreements which, if met by an investment company organized under Canadian law, will enable the company to obtain a Commission order permitting its registration. These conditions have generally been followed by the Commission staff in considering applications regarding other countries. The Commission has, however, recently issued informal guidelines for case-by-case consideration of such applications not only under § 7(d) but also under the broad exemptive powers of § 6(c). SEC Investment Company Act Release No. 8959, 4 CCH FED. SEC. L. REP. ¶ 47,661 (Sept. 26, 1975).

¹¹⁵ Some of the reasons undoubtedly relate to the inapplicability of the Investment Company Act to the fund itself, and perhaps to the consequential lack of regulation of the fund adviser under the Securities Exchange and Investment Advisers Acts. *See* 3 IIS REPORT, *supra* note 18, at 901-04; Bialkin, Mostoff & Weiss, *Securities Regulation Aspects*, in PARTNERSHIPS, *supra* note 113, at 345-421. Equally important are the tax advantages of creating and operating investment companies in so-called tax-haven jurisdictions. *See* 3 IIS REPORT, *supra* note 18, at 904-20; Note, *United States Taxation and Regulation of Offshore Mutual Funds*, 83 HARV. L. REV. 404 (1969).

¹¹⁶ SEC Investment Company Act Release No. 8959, 4 CCH FED. SEC. L. REP. ¶ 47,661 (Sept. 26, 1975).

¹¹⁷ *See* Cohen, *Toward an International Securities Market*, 5 LAW & POLICY INT'L BUS. 357 (1973); Address by SEC Chairman Garrett, Boston Stock Exchange, Sept. 25, 1973; Address by SEC Chairman Casey, First International Meeting on Stock Exchanges, Milan, Italy, Mar. 15, 1972.

¹¹⁸ *E.g.*, J. BAILLIE & W. GROVER, PROPOSALS FOR A MUTUAL FUND LAW FOR CANADA (1974); Gori-Montanelli & Botwinik, *Mutual Funds in Italy*, 4 INT'L LAW. 352 (1970); Thrope, *The Sale of U.S. Securities in Japan*, 29 BUS. LAW. 411, 415-16 (1974); Note, *West German Regulation of Foreign Mutual Fund Distributions*, 3 N.Y.U.J. INT'L L. & POL. 323 (1970).

¹¹⁹ ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, STANDARD RULES FOR THE OPERATIONS OF INSTITUTIONS FOR COLLECTIVE INVESTMENTS IN SECURITIES (1972). Representatives of the United States, including a representative of the Commission, participated in the deliberations of OECD that led to the promulgation of the "Standard Rules." For a digest of the "Standard Rules," *see* SEC Investment Company Act Release No. 8596, 5 SEC DOCKET 640 (Dec. 2, 1974) (request for public comments on issues raised by permitting foreign investment companies to register under the Investment Company Act).

¹²⁰ 1 IIS REPORT, *supra* note 18, at xvi-xvii:

[T]he Commission believes that foreign investor confidence in offshore funds that invest in American securities could be bolstered significantly if they were to

the Commission in 1973 proposed enactment of the Foreign Portfolio Sales Corporation Act.¹²¹ One provision of the bill would have given the Commission greater flexibility in considering applications under section 7(d) in response to the OECD's "Standard Rules."

In view of these developments in the regulation of investment companies in foreign countries, it seems appropriate to add flexibility to section 7(d) by amending it to permit the Commission in granting an order to take into account the differing laws, regulations, customs, and business conditions of particular countries and the adequacy of existing regulations in such countries.¹²²

become subject to Commission regulation under the federal securities laws. Offshore funds currently receive treatment under the Internal Revenue Code which provides them with competitive advantages over domestic, registered investment companies seeking to sell in offshore markets. Equalization of these advantages would enable U.S. registered investment companies to compete more effectively with unregulated offshore funds. . . .

....

The Commission recommends that a high level governmental task force organized to explore and develop the possibility of the establishment and regulation of Foreign Portfolio Sales Corporations [registered United States companies distributing shares to foreign investors] as well as registered offshore investment companies. We would expect such a task force to consider appropriate tax treatment for such funds and nonresident foreign investors, and methods of gathering data with respect to foreign institutional investors in order to facilitate further study of developments in this area.

¹²¹ SEC Investment Company Act Release No. 7751, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,306 (April 3, 1973). Representative Harley O. Staggers introduced the Foreign Portfolio Sales Corporation Act of 1973, H.R. 8256, 93d Cong., 1st Sess. (1973). The best description of the bill's provisions is found in the SEC-Treasury Department Memorandum dated March 27, 1973, "Description of Foreign Portfolio Sales Corporation Proposal," which accompanied the Commission's release. The bill would have: (1) amended § 7(d) to give the Commission greater flexibility in allowing registration of foreign investment companies; (2) added new § 7(e)(1) to provide for registration and regulation of domestic investment companies organized to sell their securities to foreign nationals; and (3) added new § 7(e)(2) to enable the Commission to deal with the problem of "shell" companies organized in the United States with foreign officers, directors, and trustees. Although the Commission expressed its strong support for the bill before and after its introduction, it was never the subject of hearings during the 93d Congress and has not been reintroduced in the 94th Congress.

¹²² Although the Commission recognizes that it remains bound by § 7(d), it has suggested it will use factors similar to those mentioned in the text in considering applications for exemptions under §§ 6(c) and 6(e). See SEC Investment Company Act Release No. 8959, 4 CCH FED. SEC. L. REP. ¶ 47,661 (Sept. 26, 1975).

It can be argued that the present statutory requirement that the Commission find it both "legally and practically feasible to enforce" the provisions of the Investment Company Act would conflict with a mandate to take into account the foreign country's differing laws, regulations, and so forth. If this argument is troublesome, additional language could require, as did OECD with respect to its member countries, that the Commission when considering applications under § 7(d) give substantial weight, within the regulatory

e. *Definition of "Affiliated Person"*¹²³

An officer, director, or employee of an investment company is an affiliated person of the company under section 2(a)(3)(D). No corresponding language in section 2(a)(3) explicitly directs that the company is an affiliated person of its officer, director, or employee.

Thus, an anomalous situation could develop in which two companies share a common director or officer, but one company would not be the affiliated person of an affiliated person of the other company. Section 17 reaches certain dealings of an affiliated person of an affiliated person of a registered investment company.¹²⁴ Therefore it is not clear that the section would, without more, reach dealings of a company that shares a common officer or director with the registered company.

Only in limited circumstances would the alternative definitions of "affiliated person" complete the chain. Under section 2(a)(3)(B), an investment company is an affiliated person of any person who owns five percent or more of its outstanding voting securities. Section 2(a)(3)(C) would make the company an affiliated person of the director or other person if the director or other person controls, is controlled by, or is under common control with the company. But under section 2(a)(9), a person whose power "is solely the result of an official position" with a company is excluded from the definition of controlling person. A presumption is also stated that a natural person is not a controlled person. Section 221 of the ALI Code would drop the "official position proviso" and the "natural person" presumption.¹²⁵ The

framework of the Investment Company Act, to the foreign investment company's compliance with the regulatory framework of its country's statutes and regulations.

Of course, although amending § 7(d) to give the Commission additional flexibility in allowing foreign investment companies to register is a necessary first step, substantial problems would remain. In SEC Investment Company Act Release No. 8596, 5 SEC DOCKET 640 (Dec. 2, 1974), the Commission stated that the basic questions were (1) whether it was desirable to relax certain provisions of the Investment Company Act, particularly in view of the OECD "Standard Rules," and (2) how that relaxation could be accomplished without sacrificing essential investor protections. The Release posed nine complex questions on which the Commission invited public comments.

The Commission later decided to resolve issues on a case-by-case basis, but also lent its support to legislative review of the efficacy of § 7(d). See SEC Investment Company Act Release No. 8959, *supra*.

¹²³ For a discussion of the importance of the term "affiliated person" to the conflict of interest prohibitions of § 17, see text accompanying notes 39-44 *supra*; text accompanying notes 205-20 *infra*.

¹²⁴ See notes 39-44 *supra* & accompanying text.

¹²⁵ ALI FED. SEC. CODE § 221 (Rev. Tent. Draft Nos. 1-3, 1974). The "official posi-

modifications are a helpful step, but not dispositive of the problem.

Under present law, a person owning five percent (an arbitrary number) of a company's outstanding voting securities may forge the link in both directions to make section 17 applicable while that particular person can exert no real influence over the management or policies of a company. Yet a person holding an official position, and thus able to wield great power, might not create the link. In analogous situations, where two investment companies have a common investment adviser and common officers and directors, the Commission has taken the position that common control may exist as a matter of fact, rendering the two investment companies affiliated persons of each other.¹²⁶

To obviate future arguments and to cover the more common types of interlocking situations involving a natural person, we recommend that section 2(a)(3) be amended by adding new clause (G): " 'Affiliated person' of another person means . . . and, (G) if such other person is an officer, director, or employee, any company for which such person acts in any such capacity." Under new clause (G), a company would be an affiliated person of its officers, directors, and employees. It would thus become an affiliated person of an affiliated person in respect to any person who is an affiliated person of its officers, directors, or employees. Transactions involving a registered investment company and such affiliated persons of affiliated persons would then be subject to section 17, thereby removing an inexplicable omission from the section's investor protection scheme.¹²⁷

f. *Definitions of Terms Not Currently Defined*

Several terms, including "depositor" and "officer," are used in the Investment Company Act without being defined.

tion" proviso of § 2(a)(9) has been difficult to apply and interpret. The ALI Code changes are essential to our recommended change in § 2(a)(3) of the Investment Company Act. Section 221(c) would permit filing of applications for a Commission order declaring whether or not control exists.

¹²⁶ *E.g.*, SEC Investment Company Act Release No. 4697, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,405 (Sept. 8, 1966) (adoption of rule 17a-7) (affiliation based upon control would depend upon the facts of the given situation, including extensive interlocks of officers, directors, or key personnel, common investment advisers or underwriters); SEC Investment Company Act Release No. 7035, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,608 (March 9, 1972) (proposal to amend rule 17d-1). The proposed exemptive rule would have permitted affiliated persons of affiliated persons to combine their securities transactions together with the order of a registered investment company for the sole purpose of achieving the best overall execution.

¹²⁷ This change would, of course, expand the present scope of § 17. As discussed in text accompanying notes 137-220 *infra*, we would also amend § 17 in other respects.

ALI Code section 269 defines "officer" as

(a) the chairman of the board of directors, president, treasurer, secretary, controller, or principal executive, financial, or accounting officer of a company; (b) a vice president or other employee who participates or has authority to participate, otherwise than as a director, in major policy-making functions of a company¹²⁸

The effect of this section and section 226, which defines "director,"¹²⁹ is to cover all persons who would perform such functions with respect to any type of company (as defined in ALI Code section 219).¹³⁰ We support these revised definitions.

The term "depositor" is used, among other places, in Investment Company Act sections 2(a)(3)(F), 7(b), 9(a), 10(h), 17(a)(1)(C), 26, and 27. A definition of the term is necessitated by the extent of its usage in the Investment Company Act and the importance of the provisions in which it appears. For example, section 10(a) requires that no more than sixty percent of an investment company's board of directors be interested persons, which includes affiliated persons, which in turn under section 2(a)(3)(F) includes depositors. Further, section 27¹³¹ requires a depositor of a company issuing periodic payment or contractual plans to see that planholders pay no more than the maximum sales load permitted and that the issuer meet such reserve requirements as the Commission may impose.¹³²

"Depositor" has been defined by the Commission in Form N-1R, the annual report required to be filed by registered investment companies,¹³³ but because of its importance the term

¹²⁸ ALI FED. SEC. CODE § 269 (Rev. Tent. Draft Nos. 1-3, 1974).

¹²⁹ *Id.* § 226. The term "director" is also defined in § 2(a)(12) of the Investment Company Act. While ALI Code § 226 and § 2(a)(12) contain similar thoughts and words, the ALI Code formulation appears superior because of its explicit reference to the general partner of a partnership as compared with the more general reference to "any person performing similar functions" in § 2(a)(12).

¹³⁰ ALI FED. SEC. CODE § 219 (Rev. Tent. Draft Nos. 1-3, 1974).

¹³¹ Sections 27(d)-(h), providing further regulation of the sales load paid by purchasers of periodic payment or contractual plans issued and sold by investment companies, were added by the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, § 16, 84 Stat. 1424. For a discussion of the notice and refund provisions added in 1970, see North, *supra* note 21, at 724-25. For discussions of the law and operations of periodic payment plans prior to the 1970 Act, see PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 223-50; *Mutual Fund Survey*, *supra* note 5, at 861-65.

¹³² See 17 C.F.R. §§ 270.27a-1 to a-3, 27c-1, 27d-1 to d-3, 27e-1, 27f-1, 27g-1, 27h-1 (1975).

¹³³ Rule 30a-2, 17 C.F.R. § 270.30a-2 (1975); Form N-1R is prescribed at 17 C.F.R. § 274.101 *et seq.* (1975). The form required to be filed by unincorporated management

deserves statutory treatment.¹³⁴ Based on the definition in Form N-1R, we would recommend the following as new Investment Company Act section 2(a)(11)(A):

(11)(A) "Depositor" means the person primarily responsible for the creation or operation, or both, of an investment company not having a board of directors, including any person who is designated as the sponsor or manager of the investment company and who has continuing functions or responsibilities with respect to the administration of the affairs of the investment company, but not including a trustee or custodian designated in accordance with the provisions of section 26 of the Act, unless the trustee or custodian is also the creator, sponsor, or manager of the investment company.

The exclusion of trustees and custodians designated under section 26 of the Investment Company Act is appropriate because the trust indenture or agreement of custodianship specifying a particular bank as trustee of a unit investment trust provides adequate investor protections of the kind that would otherwise be applicable under the Investment Company Act.¹³⁵

2. Fundamental Investment Policy

Section 8(b) of the Investment Company Act authorizes the Commission to require, in the registration process, disclosure of certain fundamental aspects of an investment company's intended policies and operations. These aspects include: diversification, borrowing, lending, issuance of senior securities, underwriting the securities of others, concentration of investments, purchase of assets other than securities, and portfolio turnover.

investment companies currently issuing periodic payment plan certificates is Form N-30A-3, 17 C.F.R. § 274.103 (1975).

¹³⁴ S. 3772, 86th Cong., 2d Sess. § 1 (1960), would have added a definition of the term "depositor"; the bill's definition would have included persons with the administrative function of eliminating or substituting portfolio securities, but not persons whose functions as a depositor had been assumed by another. S. REP. NO. 1759, 86th Cong., 2d Sess. 2-3 (1960). S. 3772 passed the Senate and, with amendments, the House. H.R. 2481, 86th Cong., 2d Sess. § 1 (1960); H.R. REP. NO. 2178, 86th Cong., 2d Sess. 4 (1960). It failed to pass both houses after conference and never became law. *See generally* Meeker, *Current Proposals to Amend the Federal Securities Laws*, 37 U. DET. L.J. 335 (1960).

¹³⁵ Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-bbbb (1970).

Section 13 prohibits a registered investment company from changing or deviating from its recitals of these fundamental policies without seeking and obtaining the approval of a majority of its outstanding voting securities. The classifications of policies contained in sections 8(b) and 13(a) are too broad. Specifically, the sections do not require disclosure or adherence to objectives concerning the types of securities in which a company will invest—for example, equity securities, triple A bonds, convertible preferred stock, and so forth.¹³⁶ Because nothing could be more important to a shareholder than awareness of the investment company's basic investment objectives, we recommend that sections 8(b) and 13(a) be amended to require that a company disclose the types of securities in which it intends to invest and that it not change or deviate from that statement without approval of a majority of the company's outstanding voting securities.

3. Regulation of Investment Company Transactions and Conflicts of Interest

a. *Services Rendered to an Investment Company*

Section 15 of the Investment Company Act requires that contracts with the investment company's investment adviser and principal underwriter be executed in writing and provide in substance for their automatic termination upon assignment.¹³⁷ It permits such contracts to continue beyond the original two-year term if the board of directors or a majority of the fund's outstanding voting securities annually re-approves their continuance; and it requires a majority of the disinterested directors to approve the terms of the contracts. The draftsmen adopted those requirements because of the lack of arm's-length bargain-

¹³⁶ Section 8(b)(2) requires disclosure of all investment policies changeable only by a shareholder vote; § 8(b)(3) requires disclosure of all matters which the investment company deems to be fundamental policy. Thus, under present law an investment company may voluntarily disclose and adhere to specific investment objectives; but it may also structure the corporate charter and by-laws to preclude any voting by shareholders on investment objectives and deem those objectives not to be a matter of fundamental policy. Meeker, *supra* note 134, at 347-48 (analysis of gap in §§ 8(b) and 13 in context of SEC's 1959-60 legislative proposals).

¹³⁷ See notes 38, 43 *supra*. Section 15(a) also requires that an investment advisory contract describe precisely all compensation to be paid thereunder and be terminable at any time, upon sixty days' written notice and without the payment of any penalty, by the board of directors or by vote of a majority of the outstanding voting securities.

ing between the investment company and its investment adviser.¹³⁸

In recent years the trend has been to contract out to affiliated persons of the investment adviser or principal underwriter certain duties, such as recordkeeping or stock transfer activities.¹³⁹ These duties were traditionally undertaken either by the investment company itself or by unrelated third parties (typically commercial banks) otherwise in the business of providing such services.¹⁴⁰ In terms of their dollar impact, contracts for administrative services may be as material to investment company shareholders as the investment advisory or principal underwriter contracts¹⁴¹ and are surely as central to the efficient

¹³⁸ SECURITIES & EXCHANGE COMM'N, REPORT ON INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. DOC. NO. 279, 76th Cong., 3d Sess., pt. 3, at 1918-40 (1940) (devices of control and related problems—management contracts); *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking & Currency*, 76th Cong., 3d Sess., pt. 4, at 1113 (1940) (Statement of David Schenker, Chief Counsel, Investment Trust Study, SEC: "[Section 10] will provide the independent directorships where you have a management contract."); *Mutual Fund Survey*, *supra* note 5, at 800-02. For a thorough discussion of the responsibilities of "independent" directors in the context of approval of the advisory contract, see Nutt, *supra* note 38, at 230-50.

¹³⁹ Operation of an investment company creates a variety of administrative needs, including: preparation, printing and distribution of prospectuses, shareholder reports, and proxy materials; issuance, transfer, and cancellation of share certificates; payment of dividends and capital gains distributions; custody of portfolio securities and other assets; transfer, receipt, and delivery of portfolio securities bought and sold; and computation, usually at least once daily, of offering and redemption prices of the investment company's shares. PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 86-87; *Mutual Fund Survey*, *supra* note 5, at 885-86.

¹⁴⁰ E.g., PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 90-94; *Mutual Fund Survey*, *supra* note 5, at 885-86, 891-904. Both the Commission and the Survey found that the services least often covered by the basic advisory fee were custodial, stock transfer, dividend disbursement, audits, and reports to shareholders. These services were almost invariably furnished by a commercial bank or trust company. PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 91-92; *Mutual Fund Survey*, *supra* note 5, at 891-92. For a discussion of the expanded concern over the choice of custodian banks by pension funds, produced by uncertainty over the Employee Retirement Income Security Act, see Patocka, *Custodian Banks, The Next Pension Battleground*, INSTITUTIONAL INVESTOR, Sept., 1975, at 87.

¹⁴¹ In 1966 the Commission cited the arrangements of Keystone Custodian Funds as a typical example of administrative-fee agreements. The investment adviser to the Funds charged for its investment advice 0.5% of the net assets under management of the first \$150 million, and for its administrative services and expenses 0.25% on the first \$500 million. Both fees scaled down with increased asset size. On June 30, 1966, Keystone had combined assets of \$1.1 billion. The advisory fee actually charged was 0.35% of average net assets; the administrative fee, 0.21%. PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 92-93. Examples of several unusual arrangements were also noted. An independent investment adviser of Washington Mutual Investors Fund, Inc., received a 0.25% fee; a wholly owned affiliate of the fund's principal underwriter received another 0.25% as "business manager"; yet the fund itself bore the expense of stock transfer, custodial, legal and auditing fees, and the cost of preparing shareholder reports. *Id.* 93-94; see *Mutual Fund Survey*, *supra* note 5, at 885-86 n.1019.

operation and success of an investment company as are its investment decisions.

Because investment companies and unrelated third parties otherwise in the business of providing administrative services would typically bargain at arm's length over contracts for administrative services, the draftsmen of the Act did not give the Commission specific statutory responsibility to oversee these contracts, nor did it give the disinterested directors of an investment company greater responsibility therein than that provided by state law.¹⁴² These contracts between an investment company and an affiliated person (or an affiliate of an affiliate) are not subject to the review procedures of section 15 and may not be within the conflict of interest prohibitions of sections 17(a)¹⁴³ or 17(d).¹⁴⁴ The investment company's personnel and the af-

¹⁴² For a thorough discussion of state law duties of "independent" directors, see Nutt, *supra* note 38, at 202-07.

¹⁴³ It might be argued that execution by an investment company of a contract for administrative services with an affiliated person is a sale by the affiliated person of "other property" to the investment company within the meaning of § 17(a)(1). Cf. Ivy Fund, Inc., SEC Investment Company Act Release No. 6509, [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,069 (May 6, 1971) (consideration to be paid by investment adviser for license to use mutual fund's name for itself was found not to be fair and reasonable; § 17(b) application for exemption from § 17(a)(2) denied); Union Data Service Center, Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,994 (SEC staff letter, July 24, 1972) (no-action letter given where an affiliated broker-dealer wished to utilize the data processing services of an affiliate of the investment company on terms of cost of services plus 15%).

If execution of an administrative services contract with an affiliated person is within § 17, the crucial reviewing standards of § 17(b) ("reasonable and fair and do not involve overreaching on the part of any person concerned") seem more appropriate to the problem than those of § 17(d) (participation by the investment company in a joint transaction with an affiliated person must not be "on a basis different from or less advantageous than that of [the] other participant"). Jurisdiction over execution of the contract is much clearer, however, under § 17(d). See note 144 *infra*.

¹⁴⁴ The Commission staff has for some time asserted the applicability of § 17(d) to the execution with an affiliated person of a contract for transfer agency services. See Investment Company Act Release No. 8245, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,667 (Feb. 25, 1974). Indeed, but for an express exclusion in rule 17d-1, 17 C.F.R. § 270.17d-1 (1975), some people feared even an investment advisory contract, subject to § 15, would fall under § 17(d). Rule 17d-1(c) defines "joint enterprise or other joint arrangement or profit-sharing plan to mean any written or oral plan, contract . . ." As originally adopted, the rule had no express exclusion; commentators expressed concern that it would also cover advisory contracts. See SEC Investment Company Act Release No. 2226, [1952-1956 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,362 (Sept. 12, 1955). Thus, a clause was added to the end of paragraph (c) to exclude "an investment advisory contract subject to Section 15 of the Act." SEC Investment Company Act Release No. 2472, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,501 (Jan. 10, 1957). The point, of course, is that if an investment adviser would be dealing as a principal in a joint enterprise, so would a transfer agent. The adviser has been expressly excluded; the agent has not been.

In 1969 the investment adviser to Pace Fund, Inc. wished to establish a wholly owned

filiated person also may not, in respect to those administrative services contracts, be subject to the fiduciary duty provisions of sections 36(a) and 36(b).¹⁴⁵ But the relationship of the parties

subsidiary to act as the fund's transfer agent; we understand the Commission staff asserted the applicability of § 17(d) to the proposed arrangement, but took a no-action position based on representations that the transfer agency services would be provided at cost. [No citation to public documents is available.] And in 1971, former Commissioner Hugh G. Owens noted:

Another area involving compensation which is of some concern is the possible application of Section 17(d) of the Act to transfer agency arrangements between an investment company and its investment adviser or an affiliate of the adviser. The banking community, which has historically performed the transfer agency function, appears increasingly reluctant to provide this service to investment companies. A trend is developing, therefore, where investment advisers undertake the transfer function themselves or set up affiliated companies to do the work.

The question arises whether these transfer agency arrangements constitute joint arrangements between the investment companies and their advisers subject to the Commission's review under Section 17(d) of the Act and Rule 17d-1. The lack of arm's-length bargaining between the fund and its adviser regarding such arrangements raises the spectre of the kind of abuses which Section 17 was directed against. Thus, the Section 17(d) question would not arise where such dangers are not present as, for example, in a case where services are performed at cost or the fund itself creates its own subsidiary to perform these services. This area is still under staff consideration, and no firm determinations have yet been made.

Address by SEC Commissioner Owens, Mutual Fund Seminar, Dallas, Texas, May 6, 1971, at 5-6, BNA SEC. REG. & L. REP. NO. 101, at E-1, E-2 (May 12, 1971).

Finally, in February 1974 the Commission proposed that rule 17d-1(c) be amended to remove existing uncertainties and to clarify the ground rules under which affiliated persons enter into service contracts with the investment company. SEC Investment Company Act Release No. 8245, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,667 (Feb. 25, 1974). The proposed amendments would add new clause (ii) to paragraph (c) to exclude service contracts from the definition of "joint enterprise" if they meet certain conditions: (1) the service contract is written, approved, and renewed in the manner required for investment advisory contracts by §§ 15(a) and 15(c); and (2) a majority of the disinterested directors determine that (a) the contract is in the best interest of the company and its shareholders, (b) the services to be performed are required for the operation of the company, (c) the affiliated person can provide services at least equal in quality and nature to those provided by others offering the same or similar services, and (d) the fees are fair and reasonable in light of the usual and customary charges made by others for services of the same nature and quality. The proposed rule is reproduced at 4 CCH FED. SEC. L. REP. ¶ 48,392.

¹⁴⁵ An investment adviser to an investment company is specified by § 36(b) to have a fiduciary duty "with respect to the receipt of compensation for services, or payments of a material nature, paid by such registered investment company . . . to such investment adviser or any affiliated person of such investment adviser." Section 36(b)(4), however, excludes from the fiduciary duty provisions in subsection (b) all "compensation or payments made in connection with transaction subject to Section 17 . . ." Since, we believe, separate contracts for administrative services are subject to § 17(d), they could not be attacked *directly* under § 36(b). Payments incident to such contracts should nevertheless be taken into account in determining the reasonableness of overall management consideration in the context of § 36(b). *Hearings on H.R. 11995, S. 2224, H.R. 13,754 & H.R. 14, 737 Before the Subcomm. on Commerce & Finance of the House Comm. on Interstate & Foreign*

can be presumed to preclude true arm's-length negotiation of the contracts. We therefore recommend several amendments to clarify the regulatory scheme.

- (i) "Investment Company Manager": Recommended Changes in Sections 2, 15, and 36

Section 2 should be amended by adding a new paragraph defining "investment company manager" as any person who is an affiliated person (or an affiliate of such affiliated person)¹⁴⁶ of a registered investment company and who engages on behalf of such registered investment company to perform as its transfer agent (as defined in section 3(a)(25) of the Securities Exchange Act¹⁴⁷), to keep, prepare, or file such accounts, books, records, or other documents as the investment company may be required to keep under the Investment Company Act¹⁴⁸ or state law, or to provide any similar services with respect to the daily administration or management of the investment company. But "investment company manager" would not include the investment company's investment adviser.¹⁴⁹

The investment company manager should also be brought

Commerce, 91st Cong., 1st Sess., pt. 1, at 177-78 (1969) (testimony of SEC Chairman Hamer Budge) [hereinafter cited as *1969 Hearings*]. Section 36(b), however, applies only to the investment company's investment adviser and the adviser's affiliates. It does not apply to the investment company's principal underwriter and its affiliates, or to other affiliated persons of the investment company, if they do not otherwise have a fiduciary duty with respect to such compensation or payments.

¹⁴⁶ The need for review by the disinterested directors (or the Commission) occurs only where there is a presumptive lack of arm's-length bargaining with the person contracting to provide administrative services. Thus, it would be inappropriate to change the Investment Company Act definitions of interested person and affiliated person to include expressly within their scope all persons who carry out the functions of an investment company manager; rather, affiliation tests should be built into the definition of investment company manager to make the definition applicable only where that person is *also* an affiliated person (or an affiliated person of an affiliated person) of the investment company.

¹⁴⁷ 15 U.S.C.A. § 78c(25) (Supp., Aug. 1975).

¹⁴⁸ *E.g.*, rules adopted pursuant to §§ 30 (periodic and other reports) and 31 (accounts and records), 17 C.F.R. §§ 270.30a-1 to a-3, 30b1-1 to b1-2, 30b2-1, 30d-1 to d-2, 30f-1, 31a-1 to a-3 (1975).

¹⁴⁹ This definition should exclude only an investment company's investment adviser and not the principal underwriter or other affiliated persons of an investment company. The adviser, but not the others, is already subject to the review and fiduciary duty provisions of §§ 15(a) and 36(b). If an investment company's principal underwriter also wishes to be an investment company manager (directly or through an affiliated person) for the same investment company, it should be included within the definition, and thus be subject expressly to §§ 15, 17(a), 17(b), and 36(a) as to its arrangements for providing those services.

under the strict regulation of sections 15(c)¹⁵⁰ and 36(a)(1).¹⁵¹ To that end, those two paragraphs should be amended by adding to the list of persons subject to their requirements the new term "investment company manager."

(ii) Selling Services: Recommended Changes in Sections 17(a) and 17(b)

In view of the clear potential for overreaching, and in view of section 17's intended purpose, it would be appropriate to amend section 17(a) by adding a new paragraph (4) prohibiting any affiliated person (and any affiliate of an affiliate) acting as principal, from knowingly selling any services to the affiliated registered investment company or any company controlled by such registered company, except services which are described in section 17(e)¹⁵² or are subject to section 15(c).¹⁵³ To avoid forcing affiliated persons to file (and the Commission to process) applications for exemptive orders under section 17(b) for the

¹⁵⁰ It could be argued, as the Commission did in proposing amendments to Rule 17d-1(c), *see* note 144 *supra*, that a contractual arrangement with an investment company manager should be subject to § 15(a), as well as § 15(c). Although it would be desirable to have § 15(a)(1) apply (and thus require a contract for services to describe precisely all compensation to be paid thereunder), §§ 15(a)(2), (3), and (4) do not mesh as well with a contract for administrative services. For example, many service contracts, such as transfer agency agreements, are amended frequently and may require voting by the board of directors or investment company shareholders more frequently than annually. Thus, the cost of formal review would probably not be commensurate with the investor protections provided. Subsection (c), on the other hand, would not appear to involve any undue burdens and would require the contract with an investment company manager to be approved by the disinterested directors of the investment company.

¹⁵¹ Section 36(a)(1) authorizes the Commission to bring an action for breach of fiduciary duty involving personal misconduct, and obviously should be applicable to an investment company manager. If the investment company manager is an affiliated person of the investment adviser, § 36(b) as presently written would also be applicable, *see* note 145 *supra*, and appropriately so.

¹⁵² For a discussion of § 17(e), *see* note 44 *supra* & accompanying text.

¹⁵³ In view of the proposed addition of § 17(a)(4) and of a proviso to § 17(b), *see* notes 154-55 *infra* & accompanying text, § 17(c) would be confusing and probably superfluous. It should be deleted. Section 17(c) excepts from the prohibitions of § 17(a) any person who, in the ordinary course of business, sells to or purchases from the investment company merchandise or who enters into a lessor-lessee relationship and furnishes services incident thereto. Historically, virtually all situations involving § 17(c) have involved lease arrangements between the investment company and its affiliated persons. Solo, Bergman, Padova & Albert (SEC staff letter, Feb. 28, 1974) (concerning Capital Corp. of America); Creative Capital Corp. (SEC staff letter, April 24, 1974). One unresolved interpretive problem, however, has been in whose ordinary course of business the transaction must be. In any event, all matters presently covered by § 17(c) would clearly fall within § 17(a)(3) and new § 17(a)(4) and thus be governed by the recommended proviso to § 17(b). The recommended proviso to § 17(b), moreover, should be much more workable than the relatively vague language of § 17(c).

sale of routine services, a proviso should be added to section 17(b). Under the proviso, an application would not have to be filed where a majority of the disinterested directors¹⁵⁴ determines that: (1) the service is in the best interest of the investment company and its shareholders, and is required for the daily administration or management of the investment company; (2) such affiliated person can provide the service in a manner at least equal in nature and quality to that which can be provided by others who offer the same or a similar service; and (3) the fee for the service is fair and reasonable in light of the usual and customary charges made by others for a service of the same nature and quality.¹⁵⁵

Section 17(b) should also be amended to require the investment company to submit a quarterly report, perhaps as an amendment to Form N-1Q, regarding each contract executed pursuant to sections 17(a)(4) and 17(b), as revised.

b. *Oversight in Sections 17(a) and 17(b)*

If streamlining the oversight of purchases of routine services makes sense, could a similar approach be taken in all transactions subject to section 17(a)? What are the alternatives to the requirement of a formal application requesting a section 17(b) exemptive order?

(i) *The Oil and Gas Investment Act*¹⁵⁶

One scheme for handling conflicts of interest, analogous to our proposed modification of section 17(b) of the Investment Company Act, is section 18 of the Oil and Gas Investment Act of

¹⁵⁴ Interaction of the definitions of affiliated person and interested person should assure that the directors voting on the investment company manager's contract are totally disinterested at least in the statutory sense. See notes 123-27 *supra* & accompanying text.

¹⁵⁵ Our recommended proviso to § 17(b) closely resembles the Commission's proposed amendments to rule 17d-1(c). See note 144 *supra*. We believe that many of the problems that the comment letters raised about the amendments have been resolved in a manner responsive to the comments.

Further, because of the special nature of the finding that disinterested directors would have to make under § 17(b) with respect to services subject to § 17(a)(4), it would not appear necessary to provide special fiduciary duty provisions, such as those discussed with regard to §§ 17(b) and 17(d) generally. See text accompanying notes 169 & 201 *infra*.

¹⁵⁶ Oil and Gas Investment Act of 1972, H.R. 17082, S. 3884, 92d Cong., 2d Sess. (1972). Oil and Gas Investment Act of 1973, H.R. 6821, S. 1050, 93d Cong., 1st Sess. (1973).

Beginning in 1966, the Commission sought to remove the § 3(c)(9) exclusion from the definition of investment company for persons "substantially all of whose business consists of owning or holding oil, gas, or other mineral royalties or leases" PUBLIC

1972 (Oil and Gas Bill).¹⁵⁷ Section 18, as proposed by the Commission, contains ten subsections that roughly parallel, in terms of coverage of conflicts of interest, their counterparts in section 17 of the Investment Company Act. Section 18(a)(1) would prohibit any manager, promoter, or principal underwriter of a registered oil program,¹⁵⁸ or any affiliated persons of such persons,

POLICY IMPLICATIONS, *supra* note 8, at 329. In the Commission's draft of the mutual fund legislation, the exclusion in § 3(c)(9) would have been narrowed by making it unavailable where the oil and gas program issued redeemable securities, face-amount certificates, or periodic payment plan certificates. S. 1659, 90th Cong., 1st Sess. § 3(b)(5) (1967); S. 3724, 90th Cong., 2d Sess. § 3(b)(5) (1968); S. REP. NO. 1351, 90th Cong., 2d Sess. 36, (1968). This provision was deleted by a floor amendment prior to Senate passage of S. 3724, which died when the House took no action.

In the 91st Congress, the oil and gas provision was again included in the mutual fund legislation. This time the amendment to § 3(c)(9) would not have become effective until 18 months after passage of the bill so that the Commission and the oil and gas industry could work out a scheme for regulation through use of the Commission's exemptive authority in § 6(c). S. 2224, 91st Cong., 1st Sess. § 3(b)(5) (1969); 115 CONG. REC. 13694-97 (1969) (Senate floor debate on S. 2224). The Senate again passed the mutual fund legislation. Testimony by oil and gas industry witnesses in the House suggested that no scheme of exemptive rules under the Investment Company Act would accommodate the industry's operating structure, which was tailored to receive favorable treatment under the *Internal Revenue Code*. In its House testimony the Commission offered a compromise that would have placed limitations on sales to unsophisticated investors of limited means. 1969 *Hearings*, *supra* note 145, pt. 1, at 180, pt. 2, at 873-74 (remarks of SEC Chairman Budge); H.R. REP. NO. 1382, 91st Cong., 2d Sess. 11-12 (1970). Ultimately, however, the Conference Committee decided to drop the oil and gas provision passed by the Senate. The decision followed an agreement between the Commission and the Oil Investment Institute, a newly formed trade association of oil and gas program managers and sponsors, to cooperate in the drafting of a statute that would parallel some provisions of the Investment Company Act. The bill, however, would be especially tailored to the practices, problems, and operating methods of the oil and gas industry, thereby producing "a reasonable regulatory statute consistent with the need for protection of investors in this area." INVESTMENT COMPANY AMENDMENTS ACT OF 1970, H.R. REP. NO. 1631, 91st Cong., 2d Sess. 27 (1970).

¹⁵⁷ For purposes of convenience, all references to sections and provisions in the Oil and Gas Bill will be to the draft bill sent to Congress by the Commission. H.R. 17082, 92d Cong., 2d Sess. (1972), introduced by Representative Staggers, is generally the same as the Commission's draft, although sections are numbered in the 100's. For contemporaneous discussions of the Oil and Gas Bill, see Address by SEC Commissioner Owens, Independent Petroleum Association of America, Dallas, Texas, Oct. 16, 1972; Address by SEC Chairman Casey, Colorado Bar Association, Colorado Springs, Colorado, Oct. 13, 1972; Address by SEC Chairman Casey, Texas Bar Association, Houston, Texas, July 6, 1972, discussed in *Casey Says SEC Will Not Accept Stock Phrases or Boiler Plates for Disclosure*, BNA SEC. REG. & L. REP. NO. 160, at A-3 (July 12, 1972). Cf. Berner & Scoggins, *Oil and Gas Drilling Programs—Structure and Regulation*, 41 GEO. WASH. L. REV. 471 (1973) (discussion of the Oil and Gas Bill is in large part about staff drafts preliminary to the bill approved by the Commission and sent to Congress as S. 3884).

¹⁵⁸ These terms are defined in §§ 2(a)(19) ("manager"), 2(a)(30) ("promoter"), 2(a)(26) ("principal underwriter"), and 3(a)(3) ("oil program") of the Oil and Gas Bill. The definitions parallel those of analogous terms under the Investment Company Act. To avoid unnecessary citation, reference will be made to a definition of a term in the Oil and Gas Bill only when the definition differs materially from its expectable meaning.

from selling property to or purchasing property from the oil program unless certain conditions are met: (1) a sale must be made at cost or fair market value, whichever is less; and (2) a purchase must be made at fair market value or cost, whichever is more. Section 18(a)(2) would require the oil program to file with the Commission, and transmit to its participants, an annual report of all transactions executed under subsection (a)(1).

Section 18(g)(1) would permit the manager or principal underwriter (or any affiliated person of such persons) of a registered oil program to render services or to sell or lease equipment and supplies to the oil program, if: (1) the person is engaged, independently of the oil program and as an ongoing business, in rendering services or selling or leasing equipment and supplies to unaffiliated persons; (2) the services, equipment, and supplies are necessary in the ordinary course of the oil program's business; and (3) the compensation for the services, equipment, and supplies is competitive with prices charged by others engaged in these businesses. If the manager or principal underwriter is not otherwise engaged in those businesses, compensation for the services, equipment, and supplies must be at cost or competitive price, whichever is less, or at a price established by competitive bidding. Like section 18(a)(2), section 18(g)(2) would require the oil program to file with the Commission, and transmit to its participants, an annual report of all services, equipment, and supplies purchased under the provisions of subsection (g)(1), including data from which competitive prices could be determined.

Finally, section 22, combining elements of section 206 of the Investment Advisers Act and of rule 10b-5,¹⁵⁹ would prohibit any oil program, its manager (or any affiliated person of the manager) from engaging directly or indirectly in any fraudulent activities with respect to any investor or prospective investor in the oil program, and would authorize the Commission to define and prescribe means reasonably designed to prevent the fraudulent activities.¹⁶⁰ The Oil and Gas Bill contains no provisions parallel to sections 17(b), 17(d), 36(a), or 36(b) of the In-

¹⁵⁹ 17 C.F.R. § 240.10b-5 (1975).

¹⁶⁰ In the Investment Company Act only § 17(j) contains antifraud provisions, *see* note 26 *supra*, but an investment adviser to an investment company would be subject to § 206 of the Investment Advisers Act and, of course, all persons are within the ambit of rule 10b-5, 17 C.F.R. § 240.10b-5 (1975).

vestment Company Act;¹⁶¹ nor does it provide any review-and-approval procedure comparable to that found in section 15(c).¹⁶²

(ii) Comparison of Oil and Gas Bill Provisions with Recommended Proviso to Section 17(b)

The essential test of transactions prohibited by section 17(a), contained in section 17(b)(1), is that the proposed transaction must be fair and reasonable and must not involve overreaching on the part of any person concerned. Sections 18(a)(1)(A) and (B) would provide detailed but somewhat arbitrary guidelines in determining what is a fair and reasonable price for property purchased from or sold to an oil program. These paragraphs require that the price in such transactions be cost or fair market value, whichever would be of greater benefit to the oil program. It is possible, of course, that a fair and reasonable price for a particular transaction would be different from cost or fair market value,¹⁶³ but the bill would trade economic accuracy for timeliness, simplicity, and certainty. The price for a specific

¹⁶¹ Provisions which specifically set forth a fiduciary duty may not be necessary if fiduciary duties may be imputed from general antifraud provisions. See *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963) (investment adviser is a fiduciary and must expose all conflicts of interest that would cause him to render advice which is not disinterested); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

¹⁶² Most oil programs that would be subject to the Oil and Gas Bill are organized as limited partnerships. The corporate structure, with directors having oversight functions, makes § 15(c) practicable for investment companies. With limited partnerships, whether one focuses on the limited partners or general partners, § 15 would be difficult to apply. Limited partners who take on management functions would lose their limited liability; persons appointed as general partners merely to serve as disinterested overseers would nevertheless be subject to general liability. Neither alternative is commercially tolerable. If the general partners are organized as a corporation, it would be theoretically possible to require that disinterested directors be appointed to serve on the board of the corporate general partner. In some states, though, a corporation cannot be a general partner of a limited partnership. In any event, such an arrangement raises serious questions about the status of the limited partnership for federal income tax purposes, putting at risk the tax shelter's "flow-through" treatment of its income and deductions. See generally R. HAFT, *TAX SHELTERED INVESTMENTS* (1973); P. REID & G. SIMMONS, *CORPORATE AND EXECUTIVE TAX SHELTERED INVESTMENTS* (1972). Thus, § 18 of the Oil and Gas Bill had to provide objective conditions for execution of transactions involving potential overreaching or require that prior Commission approval be obtained for *all* transactions involving potential overreaching.

¹⁶³ For example, it is not unusual in the oil and gas industry for the sponsor or manager of an oil program to purchase property in its own name and then immediately resell the property at a mark-up to the oil program. Sections 18(a)(1)(A) and (B) deal directly with that practice. If, however, the sponsor or manager held the property for some time before attempting to resell to the oil program, it would be possible for the fair market value of the property greatly to exceed the sponsor or manager's cost.

transaction could be readily determined; the transaction promptly executed. For routine transactions, an affiliated person wishing to deal with an oil program might well determine that the arbitrary scheme of sections 18(a)(1)(A) and (B) provides a reasonable *quid pro quo*. An affiliated person might not reach the same conclusion in the context of complicated transactions in which cost and fair market value of the property are widely disparate.¹⁶⁴

Section 17(b) of the Investment Company Act, on the other hand, forces all transactions covered by section 17(a), regardless of size or importance, into a cumbersome application procedure, preventing timely execution and, in some cases, entirely precluding consummation of the proposed transaction. An affiliated person of an investment company, then, should usually be unwilling to deal as a principal with the investment company when a proposed transaction is large, complicated, pressing, and subject to differing opinions as to a fair and reasonable price.¹⁶⁵

To offer services under section 18(g)(1)(D) of the Oil and Gas Bill, an affiliated person would have to be in the business of offering the services to unrelated third parties outside the scope of the program and would have to charge cost or a competitive price, whichever is less. Thus, an affiliate with shallow pockets and an abiding interest in keeping all aspects of his oil program to himself would have little incentive to develop an integrated line of services, vertically or horizontally. An affiliate who is

¹⁶⁴ That an affiliated person would never take transactions to the oil program when he stands to suffer large adverse economic consequences does not end the analysis. If such a transaction would otherwise be in the best interests of the oil program, the affiliated person would then be acting in a manner quite disadvantageous to the program. He might then be violating fiduciary duty under state law to deal fairly and honestly with the oil program. See W. CARY, CASES AND MATERIALS ON CORPORATIONS 550-697 (4th ed. unabridged 1969). A less arbitrary method of determining fair and reasonable prices might encourage him to fulfill his duties and not to divert opportunities from the oil program.

¹⁶⁵ The result of § 17(b)'s cumbrousness is the opposite of the result of § 18(a)(1): When the stakes are lowest and the likelihood of overreaching is in fact the least, an affiliated person is effectively prohibited from dealing with the investment company. In most low-stake, fair and reasonable transactions, an affiliated person would receive no significant special economic reward for dealing with the investment company rather than an unrelated third party. In fact, the person would be penalized by the expense of a § 17(b) application. An affiliated person behaving as a rational economic man would take a proposed transaction to the investment company, rather than to an unrelated third party, only if he believed the transaction would produce incremental economic rewards above those that would be fair and reasonable. Of course, people do not always behave as rational economic men; and undoubtedly affiliated persons might choose to deal with the investment company for reasons ranging from altruism to personal greed.

otherwise already engaged in offering the same services to unrelated third parties could charge a competitive price, no matter how favorable his economies of scale and how large his incremental profit in providing that particular service to the oil program. Again, section 18(g)(1) would sacrifice a refined test of fair and reasonable compensation for services in return for timeliness, simplicity, and certainty.

Section 17(a), as amended by proposed paragraph (4), and section 17(b), as amended by the recommended proviso, would provide a more finely tuned approach than section 18(g)(1) to the problems of fairness and overreaching: The revised sections would permit a contract for services to be executed without receiving prior approval from the Commission only if, among other conditions, the disinterested directors of the investment company are prepared to find the contract fair and reasonable in the light of their fiduciary duties to the investment company under section 36(a)(1).

(iii) Recommendations¹⁶⁶

A more delicate balance of timeliness, simplicity, and certainty on the one hand, and fairness and lack of overreaching on the other, might be reached for securities and property transactions under section 17(b) by affirming certain aspects of the existing pattern requiring prior Commission approval and by adopting to a certain extent an arbitrary pattern analogous to that provided in the Oil and Gas Bill. We would, of course, leave intact the earlier recommended proviso to section 17(b) for service transactions subject to new section 17(a)(4). As we noted with respect to section 3(a)(3), this is a complex area and it is not possible to foresee accurately all implications of each suggested change. The changes we recommend here, and with regard to section 17(d), must thus be viewed as tentative proposals.

We propose consideration of a three-tier pattern under section 17(b) for securities and property transactions described in sections 17(a)(1), (2), and (3).

The first tier would except from the application requirement of section 17(b) those proposed transactions with affiliated persons involving less than a statutorily specified *de minimis*

¹⁶⁶ For this purpose, we will assume that § 17(d) would not apply to any transaction for services between an affiliated person and the investment company, a proposition with which we disagree. See note 144 *supra*. We would, however, amend § 17(d) to preclude its applicability where § 17(a) is also applicable. See text accompanying notes 204-05 *infra*.

amount (measured as against the affiliated person) and which are arbitrarily priced at cost or fair market value, whichever is in the investment company's best interest.¹⁶⁷

The second tier would consist of proposed transactions which the disinterested directors¹⁶⁸ of the investment company are willing to find fair and reasonable, subject of course to the fiduciary duty provisions of section 36(a)(1).¹⁶⁹

Some might suggest that placing these additional responsibilities on the disinterested directors is self-deluding.¹⁷⁰ We would argue, however, that the thrust of much of the Commission's present enforcement program is to place greater emphasis on the men on the spot, making them the first level of review for compliance with the federal securities laws.¹⁷¹ We would further note that the Investment Company Amendments Act of 1970, itself the product of lengthy Commission study, also placed great emphasis on the integrity and competence of the disinterested directors.¹⁷² Recent events have provided en-

¹⁶⁷ The fact that the first tier is arbitrary with respect to price would not, of course, permit the affiliated person to sell undesirable securities or property to the investment company. In our view, an investment adviser (who generally would be the person dealing with the affiliated person) would breach *its* fiduciary duties to the investment company if it accepted securities or other property that did not conform to the investment company's investment policy or that were otherwise unacceptable or undesirable.

¹⁶⁸ One would expect, of course, that a director who is disinterested in the statutory sense, but is interested in fact in the particular transaction, would disqualify himself from consideration of and voting on that transaction.

¹⁶⁹ One would expect the second tier to be used by an affiliated person to achieve prompt action where the disinterested directors could easily find the terms of the proposed transaction to be fair and reasonable; by the same token, the disinterested directors would presumably take very seriously their fiduciary duties and should drive very hard bargains. Thus, an affiliated person may be willing to forgo the promptness of the second-tier procedure voluntarily in return for a slower Commission review of a proposed transaction in order to take the calculated risk that the Commission may allow him a "fairer" profit on the transaction than would the disinterested directors. A three-tier system should reduce the number of applications for exemptive orders, leaving for review only those situations in which direct Commission involvement is necessary and appropriate for the protection of investors.

¹⁷⁰ See, e.g., *Management Fee*, *supra* note 19, at 739 (remarks of Abraham L. Pomerantz): "Who picks the unaffiliated directors? The affiliated men pick the unaffiliated men. The men who need to be watched pick the watchdogs to watch them."

¹⁷¹ See, e.g., Address by SEC Commissioner Sommer, First National Conference on Current SEC Developments, AICPA, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,620 (Jan. 1974); Address by SEC Commissioner Sommer, Section on Banking, Corporation, and Business Law, New York State Bar Association, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,631 (Jan. 24, 1974); American Bar Ass'n National Institute, *Proceedings: Advisors to Management: Responsibilities and Liabilities of Lawyers and Accountants*, 30 BUS. LAW. 1 (Special issue, March 1975); SEC v. Stirling Homex, SEC Litigation Release No. 6960, [Current] CCH FED. SEC. L. REP. ¶ 80,218 (July 2, 1975) (release and consent order concerning Merrill Lynch, Pierce, Fenner & Smith, Inc.).

¹⁷² See notes 22, 26, 38 & 43 *supra*.

couraging evidence that investment company directors can and will exercise their responsibilities in the manner contemplated.¹⁷³ Finally, we would expect disinterested directors to follow procedures similar to those used in section 15(c) to obtain detailed information, to have the information reviewed by independent financial analysts and independent legal counsel, and otherwise to create a formal record carefully documenting the facts and reasons that persuaded them that the proposed transaction was fair and reasonable and in the best interests of the investment company. If our recommendations are adopted, the Commission could be expected to publish rules or guidelines providing factors for disinterested directors to consider in reviewing proposed transactions.

The investment company would be required to file a quarterly report¹⁷⁴ detailing the transactions consummated under the first and second tiers, as would be required under section 18(a)(2) of the Oil and Gas Bill.

On the third tier would be proposed transactions which fall within a zone of reasonableness but which the disinterested directors are unable or unwilling to find to be fair under the second tier procedures. Here the traditional application procedure contemplated by section 17(b) would operate, culminating in a formal Commission order finding fairness and a lack of overreaching on the part of any person involved.¹⁷⁵

In our view, this three-tier system would force the affiliated person (at the first tier) or the disinterested directors (at the

¹⁷³ Compare *Ivy Fund, Inc.*, SEC Investment Company Act Release No. 8687, 6 SEC DOCKET 360 (Feb. 25, 1975) (exemptive order permitting appointment of interim investment adviser after the investment company's board of directors terminated its agreement with the prior investment adviser), with *Rosenfeld v. Black*, 445 F.2d 1337 (2d Cir. 1971), cert. dismissed, 409 U.S. 802 (1972) (sale of fiduciary office for profit prohibited) and *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied, 404 U.S. 994 (1972) (advisers must present to disinterested directors the possibility of establishing a broker-dealer affiliate for the purpose of recapturing brokerage commissions on behalf of the mutual funds).

¹⁷⁴ This information could easily be added to Form N-1Q.

¹⁷⁵ The Commission has been criticized for reading this phrase, as it plainly can be read, as a mandate for reviewing each proposed transaction from the standpoint of any person involved in the proposed transaction, not just the investment company. See, e.g., Comment, *supra* note 39, at 992-93, 1003. Although we believe that Commission decisions most often criticized—those involving Talley Industries and General Time Corporation, and Bowser, Inc.—were correct and justified in terms of the language presently in § 17(b)(1) and its legislative history, see *id.* 988-93; note 42 *supra*, the paragraph could be rephrased in the interest of clarity to read “and do not involve overreaching of the investment company on the part of any person concerned.”

second tier) to weigh and balance competing interests in reasonably delineated situations, allowing business decisions to be made expeditiously, with little cause for concern for unfairness to or overreaching of an investment company. Quarterly reports would permit indirect Commission oversight. Private rights of action by investment company shareholders¹⁷⁶ would serve a prophylactic function.

c. *Section 17(d) Generally*

Section 17(d) of the Investment Company Act prohibits any affiliated person (or any affiliated person of such person) acting as principal, from effecting any transaction in which the registered investment company (or a company controlled by the registered investment company) is a joint, or a joint and several, participant with the affiliated person in contravention of such rules as the Commission may prescribe.¹⁷⁷ Thus, while sections 17(a) and 17(b) are concerned with unfairness and overreaching in transactions in which the investment company and its affiliate are on opposite sides of the table, section 17(d) was intended to regulate those situations in which the investment company and its affiliate are on the same side of the table.¹⁷⁸ Nevertheless, it

¹⁷⁶ It has long been settled that an investment company shareholder has a private right of action, but recent cases have held that a target company lacks standing to complain about an alleged lack of compliance by the offeror company with the registration and regulatory provisions of the Investment Company Act. *See SEC v. General Time Corp.*, 407 F.2d 65 (2d Cir. 1968), *cert. denied*, 393 U.S. 1026 (1969) (target company lacks standing to complain of acquisition of its stock absent compliance with the prior approval procedure of rule 17d-1); *Nachman Corp. v. Halfred, Inc.*, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,455 at 95,595 (N.D. Ill. 1973) (target company lacks standing to seek relief for alleged violation of the registration and regulatory provisions of the Investment Company Act). In our view, these cases evidence an unfortunate trend predicated upon an unduly narrow reading of the policies underlying the Investment Company Act and are at variance with the general judicial trend of granting standing to persons who have suffered injury. *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969). *But cf.* *Blue Chip Stamps v. Manor Drug Stores*, 95 S. Ct. 1917 (1975).

¹⁷⁷ Rule 17d-1, 17 C.F.R. § 270.17d-1 (1975). Paragraph (c) of rule 17d-1 defines the phrase "joint enterprise or other joint arrangement or profit-sharing plan" and paragraph (a) requires an application to be filed for each such "arrangement." Paragraph (b) sets forth the standard for Commission approval of the application: that the registered investment company's participation in the proposed transaction will not be "on a basis different from or less advantageous than that of other participants." For a representative sampling of the types of transactions that have been found to be within the ambit of § 17(d) and rule 17d-1, *see* 4 CCH FED. SEC. L. REP. ¶ 48,399.

¹⁷⁸ The initial Investment Company Act bills introduced in 1940, S. 3580 and H.R. 8935, included a § 17(a)(4) which prohibited joint transactions, although applications for exemptive relief could have been filed under § 17(b). H.R. 8935, S. 3580, 76th Cong., 3d

would be possible to amend section 17(d) along the lines of the proposed amendments to section 17(b), thus obviating the need for filing applications for routine transactions and defining more

Sess. §§ 17(a)(4), 17(b) (1940). In language very similar to present § 17(d), § 17(a)(4) would have authorized the Commission to prescribe rules for the purpose of "(A) limiting or preventing participation by such company on a basis different from or less advantageous than that of such other participant, and (B) protecting the independent investment and managerial judgment of such company." The Senate hearings on S. 3580 are replete with examples of self-dealing transactions of the type described in §§ 17(a)(1) to (a)(3), but not § 17(a)(4). *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess., pt. 1, at 256-65 (1940) (remarks of Mr. Schenker) [hereinafter cited as *Senate Hearings*]. S. 4108 and H.R. 10065, substitutes for S. 3580 and H.R. 8935, were introduced subsequent to the hearings on S. 3580 after five weeks of negotiation between representatives of the investment company industry and the Commission. H.R. 10065, S. 4108, 76th Cong., 3d Sess. (1940); S. REP. NO. 1775, 76th Cong., 3d Sess. 1-2 (1940). The substitute bills contained the present § 17(d), but the legislative history of the reason for the change from § 17(a)(4) to present § 17(d) is limited to Mr. Schenker's recitation of the broad purposes of § 17. *Senate Hearings*, *supra*, pt. 4, at 1116 (remarks of Mr. Schenker). For contemporaneous discussions of § 17 which also focus on the anti-self-dealing provisions, see Jaretzki, *The Investment Company Act of 1940*, 26 WASH. U.L.Q. 303, 317-19, 321 (1941); Thomas, *The Investment Company Act of 1940*, 9 GEO. WASH. L. REV. 918, 937 (1941); Note, *The Investment Company Act of 1940*, 41 COLUM. L. REV. 269, 288-89 (1941); Federal Legislation, *The Investment Company Act of 1940*, 29 GEO. L.J. 614, 623-24 (1941); Note, *Regulation of Investment Companies*, 88 U. PA. L. REV. 584, 592, 606 (1940); Comment, *The Investment Company Act of 1940*, 50 YALE L.J. 440, 449 (1941).

The legislative history of § 17(d) does, however, offer some possible insights. First, the draftsmen clearly had two concerns: (1) the price at which an investment company would participate in a joint transaction and (2) the independence of judgment to be exercised where an investment company was dealing with one of its affiliated persons. Second, the draftsmen recognized that with joint transactions, unlike other self-dealing transactions, the problem was not only one of overreaching or unfairness, but one bottomed on the special access enjoyed by affiliates. Third, despite an enormous study of investment companies and the many grossly abusive transactions perpetrated upon them during the 1930's, the draftsmen were unwilling to define precisely the types of joint transactions which concerned them—rather, they chose to leave the whole problem to Commission rulemaking. And, finally, removal of the paragraph prohibiting joint transactions from § 17(a) to a separate subsection suggests that the review standards of § 17(b) might not have been considered entirely appropriate for § 17(d)-type transactions; removal, however, need not be construed as implying that the application procedure of § 17(b) was itself considered inappropriate.

Indeed, the initial rule adopted under § 17(d) by the Commission in 1946 also provided for applications to be filed in all circumstances, although the application was to become effective the tenth day after filing unless the Commission issued a notice ordering a public hearing on the application. SEC Investment Company Act Release No. 858 (Feb. 8, 1946). For subsequent amendments to rule 17d-1, see SEC Investment Company Act Release Nos. 1060 (May 23, 1947); 1598 (Mar. 20, 1951); 2472, [1957-1961 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,501 (Jan. 10, 1957); 3361, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,806 (Nov. 17, 1961); 6154 [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,847 (Aug. 10, 1970); & 8542 [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,982 (Oct. 15, 1974). The amendments generally have refined the rule to follow more closely the language of § 17(d), or have excepted from the rule certain classes of transactions. See text accompanying notes 182-86 *infra*.

precisely the types of persons and transactions subject to the requirements of the section.

(i) The Exceptions Under Rule 17d-1

Paragraph (d) of rule 17d-1¹⁷⁹ provides that an application need not be filed respecting proposed joint transactions under five circumstances. First, a profit-sharing, stock option, or stock purchase plan of a controlled company of an investment company is not required to file an application if no individual participant in the plan is an affiliate of the investment company, its investment adviser or principal underwriter, and if no participant has been such an affiliated person during the life of the plan and for six months prior thereto. Second, a pension plan for the registered investment company or any controlled companies and their employees which is qualified under section 401 of the Internal Revenue Code¹⁸⁰ need not file an application. Third, any arrangement regarding credit or securities between a bank and an SBIC¹⁸¹ where the bank is an affiliate of the SBIC, will not require prior approval from the Commission;¹⁸² nor, fourth, will issuance of stock options qualified under section 422 of the Internal Revenue Code.¹⁸³ Finally,¹⁸⁴ subsection (d)(5) of rule 17d-1 permits joint transactions between a registered investment company, or a controlled company, and an affiliate of the investment company without obtaining prior Commission approval where: (1) certain key persons of the investment company do not also have a financial interest¹⁸⁵ in the joint transaction; and (2) neither the investment company nor

¹⁷⁹ 17 C.F.R. § 270.17d-1(d) (1975).

¹⁸⁰ INT. REV. CODE OF 1954, § 401.

¹⁸¹ SBICs are those investment companies licensed under the Small Business Investment Act of 1958, 15 U.S.C. § 662 (1970), as amended 15 U.S.C. § 662 (Supp. III, 1973); see text accompanying notes 77-80 *supra*.

¹⁸² The SBIC is, however, required to file reports with the Commission containing pertinent details. Rule 17d-2, Form N-17D-1, 17 C.F.R. §§ 270.17d-2, 274.200 (1975).

¹⁸³ INT. REV. CODE OF 1954, § 422.

¹⁸⁴ The Commission has proposed another paragraph (d) (4), which would permit affiliated persons of a registered investment company to combine purchase or sale orders with those of the investment company for the sole purpose of achieving best overall execution, but it has not been adopted. SEC Investment Company Act Release No. 7035, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,608 (Mar. 9, 1972). The industry, however, has been "bunching" the transactions of investment companies in a complex of funds under a no-action position issued in late 1971. Ropes & Gray (SEC staff letter, Dec. 10, 1971) (concerning undisclosed client).

¹⁸⁵ "Financial interest" for the purposes of paragraph (d)(5) is defined not to include, *inter alia*: "(a) any interest through ownership of securities issued by the registered investment company; . . . (c) usual and ordinary fees for services as a director; . . . (e) an

a controlled company commits in excess of five percent of its assets to the joint transaction.

(ii) The Oil and Gas Bill

Sections 18(b) and 18(c) of the Oil and Gas Bill¹⁸⁶ were designed to protect oil program participants from overreaching by managers and sponsors of an oil program through their opportunity to manipulate properties and drill for their own benefit on property contiguous to the oil program's property or on any prospect in which the oil program also has an interest. Section 18(d)¹⁸⁷ provided that, for purposes of sections 18(a)¹⁸⁸ and 18(c),¹⁸⁹ a manager or controlling person of an oil program shall not be deemed to own an oil or gas interest or to drill for its own account: (1) solely by reason of its participation or interest in a registered oil program, or (2) where the manager or controlling person retains the same proportionate interest in all properties in which the oil program owns an interest and the manager or controlling person is obligated to participate with such programs in the exploration and development of the property on a cost basis proportionate to its retained interests in such properties. Thus, where an oil program and its manager or controlling person would participate jointly in the development of particular properties the effect of sections 18(d)(1) and (d)(2) would have been to provide a precise but arbitrary determination of fairness by limiting the manager to no more than its proportionate share as measured by its cost basis in the retained interests.¹⁹⁰

(iii) Comparison of Oil and Gas Bill Provisions with Rule 17d-1

Section 18(d) of the Oil and Gas Bill provides a precise, albeit arbitrary, guideline of fairness in transactions where an

interest of an insurance company arising from a loan or policy issued . . . to a natural person" 17 C.F.R. § 270.17d-1(d)(5)(iii) (1975).

¹⁸⁶ H.R. 17082, S. 3884, 92d Cong., 2d Sess. §§ 18(b), (c) (1972); see note 156 *supra*.

¹⁸⁷ *Id.* § 18(d).

¹⁸⁸ *Id.* § 18(a).

¹⁸⁹ *Id.* § 18(c).

¹⁹⁰ Because § 18(b) really provided an exception from the "for his own account" treatment of a manager or controlling person of an oil program, persons not complying with subparagraphs (1) or (2) of § 18(d) would be thrown back on the provisions of § 18 generally, thereby limiting compensation in the manner described above. See text accompanying notes 156-62 *supra*.

Also since a manager or controlling person would not be likely to have a cost basis lower than the oil program's because the property transferred to the oil program subject

affiliate and the oil program are participating in a joint transaction. An affiliate can buy an interest in an ongoing oil program, but only on the same terms as a public investor.¹⁹¹ This is roughly parallel to the requirement in section 17(d) of the Investment Company Act and rule 17d-1(b)¹⁹² that an investment company not participate in a joint transaction with an affiliated person respecting the same security "on a basis different from or less advantageous than that of any other participants," although an affiliated person of an investment company would still have to get prior Commission approval.¹⁹³ An affiliate of an oil program should, then, be willing to purchase an interest in an ongoing oil program only if the oil program otherwise appeared to be a wise investment, since he would be denied any advantage deriving from his special relationship. An affiliate of an investment company, on the other hand, should be willing to purchase securities that are also being purchased by the investment company only if the expected performance of the security appeared to be exceptional, because he would have the burden of filing an application seeking prior approval from the Commission in addition to his being denied any advantage deriving from his special relationship with the investment company.¹⁹⁴

to the retained interests would have been subject to § 18(a), the inhibiting effect of § 18(d) would parallel that of § 18(a). See text accompanying notes 162-64 *supra*.

¹⁹¹ Section 22(d) of the Investment Company Act could also mandate a similar result if the affiliated person were purchasing shares issued by the investment company (rather than shares of another company which the investment company was also purchasing or selling), although subsection (h) of rule 22d-1 permits certain affiliated persons of an investment company to purchase shares in the investment company at less than the full sales load otherwise described in the investment company's prospectus. 17 C.F.R. § 270.22d-1(h) (1975).

¹⁹² 17 C.F.R. § 270.17d-1(b) (1975).

¹⁹³ Rule 17d-1(d)(5), 17 C.F.R. § 270.17d-1(d)(5) (1975), might be available to this type of transaction, thereby removing the need for an application, if the affiliated person were not also an officer, director, employee, investment adviser or controlling person of the investment company. See text accompanying note 185 *supra*.

¹⁹⁴ It can be argued that the affiliated person still derives an advantage from his special access to the investment company's investment plans because, in a market where the investment company's purchases or sales influenced the direction or amplitude of the market for the security that is bought or sold (perhaps due to a thin "float" or an imbalance in institutional trading in the security), the affiliate can take advantage of the investment company's clout in the marketplace to obtain a more favorable price. Assuming for the sake of argument the existence of such clout and its consequential effect on the market price of the security, it is nevertheless difficult to place much weight on this phenomenon because any unrelated third party who was in the market at the same point in time would also benefit from the investment company's influence on the market pricing mechanism. The difference, of course, between the unrelated third party and the affiliated person with special access would be the lack of inadvertence in the affiliate's behavior, traceable to his special access. From the standpoint of the investment company,

With respect to jointly initiated joint transactions, section 18(d) would limit an affiliate of an oil program to a participation in profits and expenses proportionate with the cost of the affiliated person's investment in the property, but the affiliated person would have to retain an interest in *all* properties transferred to the oil program. Such a total commitment by an affiliate is not, however, required by section 17(d) or rule 17d-1. Thus, an affiliated person of an oil program should be unwilling to engage in jointly initiated joint transactions with the oil program unless he is a passive investor by choice, willing to share all entrepreneurial risks and rewards equally with the public participants in the oil program.¹⁹⁵ Section 17(d) and rule 17d-1, by contrast, would permit an affiliate to enter into a transaction with the investment company which was jointly initiated, subject roughly to the proportionality requirement of section 18(d) of the Oil and Gas Bill, although the affiliated person would still have to get prior Commission approval.¹⁹⁶ An affiliate of an investment company, then, should be willing to purchase or sell securities in a joint transaction with the investment company only if the expected performance of the security appears to be exceptional, because he would have to file an application with the Commission seeking prior approval and would also be denied any advantage deriving from his special relationship.¹⁹⁷

however, there would be little, if any, discernible damage from the parasitic behavior of its affiliate.

Because of the suggestive implications of "free-riding" by affiliates on an investment company's investment decisionmaking, many investment companies have adopted codes of ethics prohibiting such behavior. Proposed rule 17j-1, discussed in the text accompanying note 26 *supra*, would require all investment companies to adopt codes of ethics that would prohibit affiliates of the investment company from reaping any advantage in the marketplace gained from knowledge of its investment decisionmaking.

¹⁹⁵ This arrangement may, however, be sound from the affiliate's standpoint if one's analysis of the economic risks related to exploration and development of oil and gas properties were that having public investors supply a large portion of the risk capital balanced favorably in the affiliate's favor, as compared with sharing entrepreneurial rewards which were infrequent but more than adequate when they occurred.

¹⁹⁶ See note 193 *supra*.

¹⁹⁷ As was discussed, note 194 *supra*, it can be argued that "free-riding" by an affiliate is parasitic on the investment company's clout in the marketplace and thus public policy should prohibit an affiliate from taking advantage of his special relationship. In a sense, a jointly-initiated joint transaction may provide an opportunity for a bigger "free-ride" than joining a transaction in midstream because the affiliate would not just be taking advantage of his special access to gain knowledge of existing transactions but using his special access to initiate entire transactions. Again, however, if the investment company is shown especially attractive transactions by affiliates because the affiliates can "free-ride," should public policy prevent or inhibit affiliates from bringing attractive transactions to an investment company so long as the investment company is materially advantaged by the relationship?

d. Recommended Changes to Section 17(d)

With respect to joint transactions between an affiliate and the investment company involving securities or property, we believe that a more sensitive balance might be struck under section 17(d) by combining the existing pattern requiring prior Commission approval with a scheme of regulation analogous to that provided in the Oil and Gas Bill.

(i) Prior Approval Procedure

First, as was suggested with respect to section 17(b),¹⁹⁸ we propose consideration of a three-tier pattern for transactions within the scope of section 17(d). The first tier would except from the application requirement of section 17(d) those proposed joint transactions with affiliated persons that are below a statutorily specified *de minimis* amount (measured as against the affiliated person) and are arbitrarily priced at the same price the investment company would obtain.¹⁹⁹ The second tier would consist of proposed transactions above the *de minimis* amount which the disinterested directors²⁰⁰ of the investment company are willing to agree to, subject of course to the fiduciary duty provisions of section 36(a)(1)²⁰¹. As to transactions executed under both the first and second tiers, the investment company would be required to file a quarterly report detailing the consummated transactions, as it would under section 17(b).²⁰² The third tier, to be used when disinterested directors are unable or

¹⁹⁸ See text accompanying notes 166-76 *supra*.

¹⁹⁹ As we noted with respect to § 17(b), see text accompanying note 167 *supra*, the fact that the first tier would be arbitrary with respect to the price to be received by the affiliated person would not permit the affiliated person to initiate or participate in joint transactions respecting undesirable securities or property. In our view, an investment adviser would breach its fiduciary duties to the investment company if it accepted proposed transactions respecting securities or property which did not conform to the investment company's investment policy or otherwise were not acceptable or desirable. In any event, a *de minimis* amount of "free-riding" should not influence an investment adviser to take undue risks when the affiliated person stands to reap only a *de minimis* profit. For an earlier unsuccessful attempt to revise rule 17d-1 along somewhat similar lines, see SEC Investment Company Act Release Nos. 5128, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,477 (Oct. 13, 1967) (proposed amendments); 5874, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,758 (Nov. 7, 1969) (withdrawal of proposed amendments).

²⁰⁰ See note 168 *supra*.

²⁰¹ See notes 169-73 *supra*. Again, in most circumstances, special access should not tempt independent directors to risk violation of their fiduciary duties, thereby suggesting continued independence in decisionmaking as to the investment company's purchases and sales.

²⁰² See note 174 & accompanying text *supra*.

unwilling to agree to the proposed transaction under the second tier procedures, would be the traditional application procedure presently contemplated by section 17(d), culminating in a Commission order. As we argued with regard to section 17(b), a three tier system of this type would force the affiliated person (in first tier deals) or the disinterested directors (in second tier deals) to weigh and balance competing interests. Quarterly reports of transactions executed under the first and second tiers would permit indirect Commission oversight, as would subsequent review by investment company shareholders.²⁰³

(ii) Standard for Review

Second, we suggest a new standard for review of proposed transactions within the scope of section 17(d). Under the present standard, a proposed transaction arguably would be eligible for a

²⁰³ See note 176 *supra*. One alternative we have considered and rejected is a rule 10b-5 type of prohibition in lieu of the present provisions in rule 17d-1. 17 C.F.R. § 240.10b-5 (1975); 17 C.F.R. § 270.17d-1 (1975). Because one concern of § 17(d) is with special access by affiliates affecting independent judgment by an investment company, there is some surface appeal to a rule 10b-5 type provision. However, 17(d) is also concerned with the relative fairness of the proposed transaction, a concept generally considered to be outside the scope of rule 10b-5. See generally *Popkin v. Bishop*, 464 F.2d 714 (2d Cir. 1972). Thus, it seems preferable to retain the direct prophylactic of prior Commission approval, as modified above, rather than rely on specialized judicial review on an ex post facto basis. The Commission recently utilized an approach that bears a close resemblance to our recommendation when it published its proposal to adopt rule 6c-2 in response to problems of Alaska Native Claims Settlement Act corporations. SEC Investment Company Act Release No. 8902, [Current] CCH FED. SEC. L. REP. ¶ 80,271 (Aug. 22, 1975).

Similarly, we have considered and rejected the alternative of amending rule 17d-1 to include a long list of "transactions" clearly covered by § 17(d), with a catch-all purporting to prohibit also any other joint transaction which is identified in rule 17d-1. One serious problem with this suggestion is that whenever a new, innovative type of joint transaction was proposed (or discerned by the Commission staff), it would take a minimum of six months to crank up the necessary administrative procedure to add that "new" joint transaction to the list in rule 17d-1. The author of the "new" joint transaction would almost certainly argue that he had been singled out for punishment prior to an impartial determination by the Commission on the merits—with all the protections of due process—in the context of a formal application for an exemptive order. Unlike section 17(a), where most of the direct conflicts-of-interest between an affiliate and an investment company can easily be identified, there are limitless ways, as Judge Friendly noted in the *Talley* case, of paralleling an investment company's activities to provide the affiliate with a "free ride." *SEC v. Talley Indus., Inc.*, 399 F.2d 396, 404 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969). Compare *SEC v. Midwest Technical Develop. Corp.*, [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 91,252 (D. Minn. 1963) (parallel purchases of securities), with *In the Matter of First Provident Co.*, SEC Investment Company Act Release No. 6400 (March 4, 1971) (registration of public offering of portfolio affiliates securities). Promulgating a list of "joint transactions" would exhaust the ingenuity of regulators and provide little, if any, additional investor protection while at the same time providing little additional comfort or guidance to affiliates.

Commission exemptive order so long as the investment company was participating in a manner not "different from or less advantageous than that of other participants," even if all of the participants on the investment company's side of the transaction were participating on equally bad terms in a very undesirable transaction.²⁰⁴ Thus, it would seem appropriate to revise the section 17(d) standard for review to require a finding that the terms of the proposed transaction are fair and reasonable *and* that the investment company will be participating on a basis "not less advantageous" than that of other participants.

(iii) Joint Applicability of Sections 17(a) and 17(d)

Third, it is possible that certain transactions may fall under both sections 17(a) and 17(d), thereby requiring the Commission to issue two exemptive orders for the same transaction. Because section 17(b) is designed to deal with transactions presenting a direct conflict of interest between an affiliate and the investment company, thereby suggesting a potential question as to unfairness and overreaching, it would be more appropriate for the entire transaction to be judged under the standards of section 17(b). The determination as to the fairness of the entire transaction required by section 17(b) should satisfy any residual concern regarding the basis for the investment company's participation with respect to all the other participants on its side of the table.

e. *The Portfolio Affiliate Problem*²⁰⁵

Section 17 prohibits any affiliated person, promoter, or principal underwriter of an investment company, or any affiliated person of such person from engaging in certain activ-

²⁰⁴ A literal reading of the present standard would disallow a proposed transaction that was in any way "different," even if the proposed transaction appeared to be fair as to the investment company. However, this anomaly has been mitigated by the Commission's review of 17(d) applications. Exemptive orders have been issued where an investment company participated in a proposed transaction on a basis different from other participants if the transaction otherwise appeared to be fair and reasonable. See, e.g., Israel Development Co., SEC Investment Company Act Release Nos. 4169 (Feb. 19, 1965) (notice of application), & 4202 (Mar. 29, 1965) (order).

²⁰⁵ The best discussions of the portfolio affiliate problem are Kroll, *The "Portfolio Affiliate" Problem*, in *THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION* 261 (R. Mundheim & A. Fleischer, Jr. eds. 1972); Comment, *The Application of Section 17 of the Investment Company Act of 1940 to Portfolio Affiliates*, 120 U. PA. L. REV. 983 (1972). See also Dudley, *Transactions with Affiliates*, in *MUTUAL FUNDS* 357 (R. Mundheim & W. Werner eds. 1970); Routier, *Affiliated Person and Section 17*, in *MUTUAL FUNDS* 369 (R. Mundheim & W. Werner eds. 1970).

ities. The definition of "affiliated person" in section 2(a)(3) is broad.²⁰⁶ Swept within its ambit by clause (B) are non-investment companies ("portfolio affiliates") five percent of whose outstanding voting securities are owned by an investment company.²⁰⁷ Taken literally then, section 17 prohibits activities between an investment company and its portfolio affiliates and the portfolio affiliates of such portfolio affiliates. For example, applications have been filed under section 17(b) regarding purchases of a portfolio affiliate's own securities by the investment company,²⁰⁸ of a third company's securities,²⁰⁹ and of property.²¹⁰ Applications have also been filed under rule 17d-1²¹¹ regarding a registered public offering of a portfolio affiliate's securities which involved the investment company,²¹² joint holding of a third company's securities,²¹³ and joint acquisition of a third company's securities.²¹⁴ As one experienced securities lawyer has quipped:

[T]he problems that can arise under the [Investment Company] Act for such portfolio affiliates or companies which, in turn, are affiliated with them should be of interest not only to 1940 Act buffs, but to any lawyer for an operating company the shares of which are the object of the affections of any mutual funds. The topic also should appeal to double-croctic fans.²¹⁵

The legislative history of section 17 concentrates²¹⁶ on self-dealing by insiders—that is, by persons who control the investment company through stock ownership or through official posi-

²⁰⁶ See text accompanying notes 123-27 *supra*.

²⁰⁷ By virtue of section 17's coverage of affiliated persons of affiliated person, § 2(a)(3)(B) must be reapplied to each portfolio affiliate to determine whether the non-investment company also has portfolio affiliates (second level portfolio affiliates).

²⁰⁸ *E.g.*, Chamberlain Mfg. Corp., SEC Investment Company Act Release No. 6394 (Mar. 22, 1971); Scripps-Howard Investment Co., SEC Investment Company Act Release No. 5175 (Nov. 27, 1967).

²⁰⁹ *E.g.*, Great American Ins. Co., SEC Investment Company Act Release No. 4989 (June 13, 1967).

²¹⁰ *E.g.*, E.I. duPont de Nemours & Co., SEC Investment Company Act Release No. 6526 (May 17, 1971) (patents and licenses).

²¹¹ 17 C.F.R. § 270.17d-1 (1975).

²¹² *E.g.*, First Provident Co., SEC Investment Company Act Release No. 6400 (Mar. 23, 1971).

²¹³ *E.g.*, Wisconsin Securities Co., SEC Investment Company Act Release No. 5708 (June 12, 1969).

²¹⁴ *E.g.*, SEC v. Talley Indus., Inc., 399 F.2d 396 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969).

²¹⁵ Kroll, *supra* note 205, at 262.

²¹⁶ H.R. Doc. No. 136, 77th Cong., 1st Sess., pt. 3, ch. VII, at 2581-2720 (1941)

tions as officers, directors, investment advisers, or principal underwriters. Neither the Commission nor Congress addressed itself to self-dealing by "downstream" affiliates.²¹⁷ Although the statutory language is quite clear, the portfolio affiliate problem does not appear to have been anticipated or intended.²¹⁸ Moreover, as an economic matter it seems probable that, absent some other relationship to an investment company, a portfolio affiliate would exercise independent judgment in any dealings with the investment company. A second-level portfolio affiliate is

(purchases and sales of portfolio securities; loans); SECURITIES & EXCHANGE COMM'N, INVESTMENT TRUSTS AND INVESTMENT COMPANIES, H.R. Doc. No. 279, 76th Cong., 1st Sess., pt. 3, ch. IV (1939) (problems in connection with shifts in control, mergers, and consolidations); *Senate Hearings, supra* note 178, pt. 1, at 256-65, pt. 4, at 1116. *See* note 178 *supra*.

²¹⁷ *Senate Hearings, supra* note 178, pt. 1, at 256-57 (remarks of Mr. Schenker):

The only thing this section [17] says is that a person who is an officer, a director, a manager, or underwriter, shall not as principal sell any property to the investment trust. . . .

....

So an affiliated person is nothing but an officer or director or any partner of his in a firm in which he is a partner. Also no corporation which he controls can sell any securities or property directly to the investment trust.

Senator Taft did raise several questions about affiliation based on § 2(a)(3)(B), but David Schenker responded by reading the definition in the proposed bill and once again characterized 5% ownership affiliation solely in the context of officers and directors:

Senator Taft: An affiliated person includes any person owning 5 percent or more of the outstanding voting securities. That makes the definition of an affiliated person, does it?

....

Mr. Schenker: That means an officer, director, any partner of his in a partnership, and any company of which he is a 5-percent owner.

....

Senator Taft: Does it go beyond that? Does it go to an affiliated person of [a portfolio affiliate of an officer of an investment company] or some other person who owns 5 percent of that company's stock, and provide that he could not sell either? Is it to the second degree?

Mr. Schenker: He [presumably the second degree affiliate] could [not] sell it. We tried to get the situations where it would be to his [presumably the officer's, a first degree affiliate] pecuniary interest to unload securities on the investment trust. We figured that if he had a 5-percent interest in the company that is selling the securities, then he has a sufficient interest to affect his judgment, and therefore we say that he cannot sell.

Senate Hearings, supra note 178, at 260-61. However, Judge Friendly, in his opinion in *SEC v. Talley Indus., Inc.*, 339 F.2d 396 (2d Cir. 1968), *cert. denied*, 393 U.S. 1015 (1969), did offer a theory as to why Congress might have intended to include portfolio affiliates: "[C]ongress could have thought that downstream affiliation also involved some danger that the investment company's stockholders might be put upon for the benefit of other stockholders of the affiliate." *Id.* at 403.

²¹⁸ All problems regarding downstream affiliates discussed in the *Senate Hearings* involved *controlled* downstream affiliates, whether control ran directly to the investment company or existed indirectly through ownership by an officer or director of the investment company. *Senate Hearings, supra* note 178, pt. 1, at 257-60.

even less likely to be susceptible to any attempt by the investment company to affect the independence of its decisionmaking.²¹⁹

Accordingly, we recommend that sections 17(a) and 17(d) be amended so a company that is a portfolio affiliate of an investment company *solely*²²⁰ by virtue of the affiliation described in section 2(a)(3)(B) will be excluded from the prohibitions of those sections.

III. THE INVESTMENT ADVISERS ACT²²¹

A. *The Regulatory Framework*

Section 203(a) of the Investment Advisers Act requires the registration of all "investment advisers."²²² The term "investment adviser" is defined broadly in section 202(a)(11) to include any person:

²¹⁹ Rules 17a-6 and 17d-1(d)(5) presently provide for similar exceptions from the prohibitions of § 17(a) and rule 17d-1, respectively. 17 C.F.R. §§ 270.17a-6, 17d-1(d)(5) (1975).

²²⁰ A company that is otherwise a portfolio affiliate of an affiliated person of an investment company should continue to be subject to the prohibitions in § 17 because, with the affiliated person's special access to the investment company, there is opportunity for precisely the type of self-dealing that the legislative history of § 17 makes plain was intended to be prohibited. See text accompanying notes 216-18 *supra*.

²²¹ 15 U.S.C. §§ 80b-1 to b-21 (1970), as amended, 15 U.S.C.A. §§ 80b-1 to b-21 (Supp., Aug. 1975); see note 2 *supra*. See generally 2 L. LOSS, *SECURITIES REGULATION* 1392-1417 (2d ed. 1961); 5 *id.* 3511-25 (Supp. 1969); Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214 (1959). For a discussion highlighting recent staff interpretations, cases, rules, and legislation affecting the Investment Advisers Act, see Lybecker, *Advisers Act Developments, Advisers Act Proposals* (pts. 1-2), 8 REV. SEC. REG. 927, 916 (1975) [hereinafter collectively cited as *Advisers Act Developments*.]

The specific legislative research and recommendations regarding enactment of a regulatory statute covering investment advisers are found in a supplemental report to the Commission's main study of investment trusts and investment companies. SECURITIES & EXCHANGE COMM'N, *INVESTMENT COUNSEL, INVESTMENT MANAGEMENT, INVESTMENT SUPERVISORY, AND INVESTMENT ADVISORY SERVICES*, H.R. DOC. NO. 477, 76th Cong., 2d Sess. (1939). The Investment Advisers Act was, of course, an integral part of the Investment Company Act legislative efforts in 1940 and 1970, and the legislative history of specific provisions may be found more readily in those documents, with the caveat expressed in note 5 *supra*. See North, *A Brief History of Federal Investment Company Legislation*, 44 NOTRE DAME LAW. 677 (1969); North, *supra* note 21, at 717-18, 728-29.

²²² The Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 29(1), 89 Stat. 97, made significant changes in the registration provisions of the Investment Advisers Act. Prior to May, 1975, the unnumbered paragraph following § 203(c)(2) mandated that an application for registration as an investment adviser automatically became effective thirty days after the Commission's receipt of the application. In the event it desired to prevent this automatic effectiveness, § 208(g) required the Commission to commence a formal proceeding to deny registration; however, under § 209(a) the Commission could seek an injunction against any person who has or is about to violate any provision of the Investment Advisers Act. Section 29 of the 1975 Act amended § 204 to conform generally to the broker-dealer registration provisions of the Securities Exchange Act of 1934, 15

who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities²²³

Because of the breadth of the definition of "investment adviser," five statutory exclusions from the definition appear in section 202(a)(11).²²⁴ Clause (A) excludes "a bank, or any bank holding company as defined in the Bank Holding Company Act

U.S.C. § 780, as amended 15 U.S.C.A. § 780 (Supp., Aug. 1975). As amended, § 203(c)(1) authorizes the Commission to require disclosure of a balance sheet certified by an independent accountant and other financial statements in addition to a statement whether the investment adviser's principal business is to act as an investment adviser and to render investment supervisory services. Section 203(c)(2) requires the Commission to grant registration or to institute proceedings to determine whether registration should be denied within forty-five days of filing the application. See SEC Investment Advisers Act Release No. 465, [Current] CCH FED. SEC. L. REP. ¶ 80,209 (June 20, 1975). Section 203(g) was deleted from the statute because it was rendered superfluous by the 1975 amendments.

Section 208(c) prohibits any registered investment adviser from representing that he is an "investment counsel" unless his principal business consists of acting as an investment adviser and a substantial part of his business consists of rendering investment supervisory services. Section 202(a)(13) defines the phrase "investment supervisory services" to mean "the giving of continuous advice as to the investment of funds on the basis of the individual needs of each client." For a recent discussion of the investment counsel industry and its background, see ADVISORY COMMITTEE ON INDIVIDUAL INVESTORS, SECURITIES & EXCHANGE COMM'N, SMALL ACCOUNT MANAGEMENT SERVICES: RECOMMENDATIONS FOR CLEARER GUIDELINES AND POLICIES, at App. E, CCH FED. SEC. L. REP. No. 465, pt. III (Feb. 6, 1973).

²²³ "Security" is defined in § 202(a)(18) in a manner identical to and is generally interpreted by the Commission in a manner consistent with § 2(1) of the Securities Act of 1933, 15 U.S.C. § 77b(1) (1970). See note 7 *supra*.

²²⁴ Section 202(a)(11)(F) also authorizes the Commission to exclude (by rule, regulation, or order) any other person "not within the intent of this paragraph." There have been very few applications under this clause. However, in the 1940's, the Commission did grant certain persons exclusion from the definition of investment adviser. *E.g.*, Marine Midland Group, Inc., SEC Investment Advisers Act Release No. 5 (Nov. 6, 1940) (exclusion granted to affiliate of bank holding company organized to give advice solely to group of twenty controlled banks and trust companies); Augustus P. Loring, Jr., SEC Investment Advisers Act Release No. 33 (July 22, 1942) (person primarily engaged in business as a professional trustee; any advice was solely incidental to services as court-appointed fiduciary). It should be noted, however, that a recent application for an order of exclusion met with stiff opposition from possible competitors in the investment advisory industries and was withdrawn when the application was set down for a hearing by the Commission. See note 226 *infra*. No rules or regulations have been promulgated by the Commission under § 202(a)(11)(F). However, the Commission recently proposed rule 202-1, which would exclude from the definition in section 202(a)(11) persons who, in the course of their regular employment, give investment advice to their employer's employee benefit plans. Proposed rule 202-1, SEC Investment Advisers Act Release No. 478, [Current] CCH FED. SEC. L. REP. ¶ 80,304 (Sept. 29, 1975).

The Commission also has exemptive power under § 206A, which was exercised most

of 1956,²²⁵ which is not an investment company.”²²⁶ Clause (B) excludes “any lawyer, accountant, engineer, or teacher whose performance of [advisory] services is solely incidental to the practice of his profession.” Clause (C) excludes “any broker or dealer whose performance of [advisory] services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor.”²²⁷ Clause (D) excludes “the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation.” Finally, clause (E) excludes any person whose advice, analyses, or reports relate solely to United States Government securities.

To further alleviate possible problems raised by the broad definition of investment adviser, section 203(b) contains three exceptions to the registration provisions of section 203(c) of the Investment Advisers Act.²²⁸ Subsection (1) excepts any investment adviser all of whose clients are residents of the state within which he maintains his principal office and place of business,

recently with respect to broker-dealers and problems associated with the unfixing of brokerage commission. *See* note 227 *infra*.

²²⁵ 12 U.S.C. § 1841(a) (1970), *as amended*, 12 U.S.C. § 1841(a)(1) (Supp. I, 1971).

²²⁶ “Bank” is defined in § 202(a)(2) to include national banks, member banks of the Federal Reserve System, and state-chartered banks and trust companies. This definition would not generally include either foreign-chartered banks or affiliates or subsidiaries of a bank or a bank holding company. Thus, nonbank investment subsidiaries of bank holding companies have been required to register under the Investment Advisers Act. Chase Investors Management Corp. New York, SEC Adm. Proc. File No. 3-3859; SEC Investment Advisers Act Release Nos. 333 (Aug. 27, 1972) (notice of application); 342 (Oct. 12, 1972) (order for hearing); & 348 (Nov. 14, 1972) (order discontinuing hearing).

²²⁷ For a discussion of recent events regarding registration of broker-dealers under the Investment Advisers Act as one implication of the Commission’s decision in rule 19b-3, 17 C.F.R. 240.19b-3 (1975), to prohibit the fixing of brokerage commission, *see* SEC Investment Advisers Act Release Nos. 455, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,160 (Apr. 23, 1975) (adoption of rule 206A-1(T)); 456, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,163 (Apr. 30, 1975) (adoption of rule 206(c)-1(T)); 470, [Current] CCH FED. SEC. L. REP. ¶ 80,268 (Aug. 20, 1975) (adoption of rule 206(3)-1); 471, [Current] CCH FED. SEC. L. REP. ¶ 80,269 (Aug. 20, 1975) (adoption of amendments to rule 206A-1(T)). *See also* *Advisers Act Developments*, *supra* note 221, at 916.

²²⁸ Excepting certain persons from the registration provisions does not have the same sweeping effect as does a statutory exclusion from the definition of investment adviser. A person excepted from the registration provisions would nevertheless still be subject to §§ 206-22, although he would not be subject to § 204 (recordkeeping) or § 205 (performance fee and other restrictions on investment advisory contracts). What a person avoids, therefore, in structuring his business to satisfy one of the clauses in § 203(b) is the one-time \$150 registration fee, the recordkeeping requirements, the performance fee restrictions, and occasional inspections by the Commission staff. The antifraud provisions of § 206, and all rules thereunder, would still be fully applicable to such a person. Pass, Fuinsbert & Augur, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,070 (SEC Staff letter, Oct. 30, 1974) (concerning TISE, Inc.).

and who does not furnish advice or issue analyses or reports with respect to securities listed (or admitted to unlisted trading privileges) on any national securities exchange.²²⁹ Subsection (2) excepts any investment adviser whose only clients are insurance companies;²³⁰ and subsection (3) excepts any investment adviser "who during the course of the preceding twelve months has had fewer than fifteen clients and who neither holds himself out generally to the public as an investment adviser nor acts as an investment adviser to any [registered] investment company"²³¹

The Investment Advisers Act follows, to some extent, the regulatory scheme of the Investment Company Act, but relies much more heavily on disclosure and the antifraud provisions of section 206 than on substantive regulation. Sections 203(e) and (f), however, authorize the Commission (after notice and opportunity for a hearing) to censure, to deny registration, to suspend for a period not exceeding twelve months, or to revoke the registration of an investment adviser or person associated with it²³²

²²⁹ See text accompanying notes 245-55 *infra*.

²³⁰ Prior to the Investment Company Amendments Act of 1970, Pub. L. No. 91-547, 84 Stat. 1430, § 203(b)(2) excepted from registration any investment adviser whose only clients were investment companies and insurance companies. Thus, advisers to registered investment companies (including separate accounts of insurance companies funding variable annuity contracts) were not required to register under the Investment Advisers Act. Narrowing the registration exception to insurance companies, defined in § 202(a)(12) to have the same meaning as in the Investment Company Act (§ 2(a)(7)), meant investment advisers to investment companies would be subject to the same registration provisions as all other types of investment advisers. See North, *supra* note 21, at 717-18. For a discussion of some of the problems relating to registration of insurance companies under the Investment Advisers Act, see *Advisers Act Developments*, *supra* note 221, at 917.

²³¹ Because any person relying on an exception or exemption from the registration provisions of the federal securities laws must carry the burden of proof that he has satisfied the conditions of the exception or exemption, an investment adviser attempting to rely on § 203(b)(3) may have some difficulty in creating negative evidence demonstrating that he does not hold himself out to the public as an investment adviser. Cf. Potomac Fed. Corp., [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,741 (SEC staff letter, Feb. 14, 1974); Potomac Fed. Corp. v. SEC, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 94,815 (D.D.C. 1974) (complaint dismissed for lack of merit; Commission action was not arbitrary or capricious). Moreover, to qualify for the exception an investment adviser is required to restrict his total clients (including all those gained and lost) to fourteen during any twelve month period. The usefulness of this exception to registration may therefore be very limited. But see Peper, Marun, Jenson, Maichel & Hettage (SEC staff letter, Jan. 28, 1975) (concerning A.G. Edwards & Sons, Inc.).

²³² The term "person associated with an investment adviser" is defined in § 202(a)(17) and was added by the Investment Company Amendments Act of 1970 to bring within the disqualifying provisions of § 203(e) persons controlling an investment adviser and employees of an investment adviser. The term "control" is defined in § 202(a)(12) as "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company." See North, *supra* note 21, at 717. Section 202(a)(17) gives the Commission

if it, or any associated person, has committed certain types of misconduct.²³³ Section 204 also empowers the Commission to adopt rules specifying which accounts, correspondence, memoranda, papers, books, and other records must be kept by a registered investment adviser,²³⁴ and authorizes the Commission to conduct such examinations of those books and records "as the Commission may deem necessary or appropriate in the public interest or for the protection of investors." Section 205 also provides a degree of substantive regulation by prohibiting an investment adviser who is subject to the registration requirement from entering into any investment advisory contract which:

(1) provides for compensation to the investment adviser on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client;²³⁵

(2) fails to provide, in substance, that no assignment²³⁶

rulemaking power to classify controlling persons falling within the ambit of § 202(a)(17). For a discussion of rules recently adopted under § 204 which utilize this power, see *Advisers Act Developments*, *supra* note 221, at 916.

²³³ Section 29 of the recently adopted Securities Acts Amendments of 1975 amended §§ 203(e) and 203(f) generally to conform to similar provisions in the Securities Exchange Act. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 29, 89 Stat. 97; see H.R. REP. No. 229, 94th Cong., 1st Sess. 79-83 (1975).

For a brief discussion of the pre-1970 Act provisions and the provisions added in 1970 regarding revocation or suspension of registration which also parallel those in the broker-dealer registration provisions of the Securities Exchange Act, see North, *supra* note 21, at 717-18. Subsections (5)(A) and (5)(B) of § 203(e), relating to an investment adviser's failure to supervise any person with a view toward preventing violations of the federal securities laws, exclude from the misconduct provisions any person who established procedures and a system that could reasonably be expected to prevent and detect violations and who reasonably discharged his duties under the system.

²³⁴ Rules 204-1 & 2, 17 C.F.R. §§ 275.204-1 & 2 (1975). For a discussion of important recent amendments to the recordkeeping requirements in rule 204-2, see *Advisers Act Developments*, *supra* note 221, at 916. Section 29 of the Securities Acts Amendments of 1975 amended § 204 of the Investment Advisers Act to define "records" as it is defined in § 3(a)(37) of the Securities Exchange Act of 1934, 15 U.S.C.A. § 78c(a)(37) (Supp., Aug. 1975), and to give the Commission rulemaking power to require public dissemination of such reports as the Commission may require. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 29(5), 89 Stat. 97; see H.R. REP. No. 229, 94th Cong., 1st Sess. 79-83 (1975).

²³⁵ The prohibitions of § 205(1) were eased somewhat by expansion of the unnumbered paragraph following § 205(3) in the Investment Company Amendments Act of 1970. For a discussion of the legislative history of the performance fee restrictions, see North, *supra* note 21, at 728-29. For a discussion of current problems involving § 205(1) and the paragraph easing its prohibitions, see *Advisers Act Developments*, *supra* note 221, at 930-31.

²³⁶ "Assignment" is defined in § 202(a)(1) to include "any direct or indirect transfer or hypothecation of an investment advisory contract by the assignor or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor"

of such contract shall be made by the investment adviser without the consent of the other party to the contract;
or

(3) fails to provide, in substance, that the investment adviser, if a partnership, will notify the other party to the contract of any change in the membership of such partnership within a reasonable time after such change.

As noted above, though, the antifraud provisions in section 206 are the heart of the Investment Advisers Act. Paragraphs (1), (2), and (4) of section 206 make it unlawful for any investment adviser to engage in fraudulent misconduct,²³⁷ and section 206(4) further authorizes the Commission to adopt rules defining and prescribing "means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative." The Commission has adopted two rules under section 206(4):²³⁸ rule 206(4)-1²³⁹ (advertisements by investment advisers), and rule 206(4)-2²⁴⁰ (custody or possession of funds or securities of clients by investment advisers). Finally, paragraph (3) of section 206 makes it unlawful for an investment adviser (acting as an investment adviser in relation to the securities transaction):²⁴¹

²³⁷ The scope of § 206 is apparently broader than rule 10b-5, 17 C.F.R. § 240.10b-5 (1975), because there is no requirement that the investment adviser's client be a purchaser or seller of securities. See note 26 *supra*. See also *Angelakis v. Churchill Management Corp.*, [Current] CCH FED. SEC. L. REP. ¶ 95,285 (N.D. Cal. June 6, 1975). With respect to recent developments in the availability of private rights of action under § 206, see *Advisers Act Developments*, *supra* note 221, at 932-34.

²³⁸ A third rule, which would establish standards for the publication, circulation, and distribution of investment advisory communications, was proposed in 1968 and is still pending. Investment Advisers Act Release No. 231, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,612 (Oct. 10, 1968) (rule 206(4)-3). A recently proposed fourth rule would mark an important departure from its predecessor rules by requiring an investment adviser to prepare and disseminate a written disclosure statement containing certain specific information about the adviser, his staff, and the types of services he performs. Investment Advisers Act Release No. 442, [1974-1975 Transfer Binder], CCH FED. SEC. L. REP. ¶ 80,128 (Mar. 5, 1975) (rule 206(4)-4). For a discussion of this so-called brochure rule, see *Advisers Act Developments*, *supra* note 221, at 917.

²³⁹ 17 C.F.R. § 275.206(4)-1 (1975). See *Intersearch Technology, Inc.*, SEC Adm. Proc. File No. 3-2991, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,139 (Feb. 28, 1975).

²⁴⁰ 17 C.F.R. § 275.206(4)-2 (1975).

²⁴¹ In Investment Advisers Act Release No. 40 (Feb. 5, 1945), the Commission published the opinion of the division director then responsible for administration of the Act regarding § 206(3). The division director stated that the disclosure and consent arrangement required by § 206(3) could not be satisfied by a general agreement, but must be satisfied before the completion of each separate transaction.

acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction

The adoption of rule 19b-3,²⁴² which prohibits fixing rates of commission by exchanges, poses severe problems for investment advisers who are also registered broker-dealers. Consequently, the Commission recently adopted rule 206(3)-1²⁴³ to remove certain "impersonal advisory services" from the reach of section 206(3). Registered broker-dealers who are investment advisers only to the extent that they make certain information available for public distribution, provide generalized advice not geared to the investment needs of any particular individual, and respond to requests for specific statistical information not involving an expression of opinion, are not required to comply with section 206(3).²⁴⁴

B. *Recommendations to Cure Errors, Omissions,
and Needless Complexities*²⁴⁵

1. Definition of "Investment Adviser"

Section 202(a)(11)(D) excludes from the definition of investment adviser "the publisher of any bona fide newspaper, news magazine or business or financial publication of general and regular circulation" Does this exclusion cover financial columnists who recommend the purchase or sale of specific securities?²⁴⁶ Two prominent securities lawyers have stated that,

²⁴² 17 C.F.R. § 240.19b-3 (1975).

²⁴³ 17 C.F.R. § 275.206(3)-1 (1975).

²⁴⁴ Rule 206(3)-1 was proposed in Investment Advisers Act Release No. 448, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,145 (Mar. 31, 1975), and adopted in a slightly modified form in Investment Advisers Act Release No. 470, [Current] CCH FED. SEC. L. REP. ¶ 80,268 (Aug. 20, 1975).

²⁴⁵ For a discussion of the legislative history of the Investment Advisers Act, see notes 5 & 221 *supra*. The SEC recently proposed amendments to the Investment Advisers Act which follow substantially the recommendations made in text accompanying notes 254-66. For the full text of the proposed amendments, see SEC Investment Advisers Act Release No. 491, [Current] SEC FED. SEC. L. REP. ¶ 80,341 (Dec. 15, 1975).

²⁴⁶ It is obvious that the publisher of a book, the producer of a radio or television show, and the person responsible for production of any other type of mass-

although the issue is a "close question," the spirit of the publisher's exclusion should extend to a syndicated financial columnist.²⁴⁷ We believe that good arguments can be made the other way, especially in view of events such as the alleged recent "scalping" operation conducted by Alex N. Campbell, a Los Angeles *Herald-Examiner* financial columnist, and his son.²⁴⁸ Although section 10(b) of the Securities Exchange Act²⁴⁹ and rule 10b-5²⁵⁰ do provide a limited method of policing such activities

communication medium should also be excluded from the definition of investment adviser. By the same token, any person who gives advice through any type of medium regarding the purchase or sale of specific securities is subject to the same policy arguments made hereinafter about financial columnists. *But see* 2 L. LOSS, SECURITIES REGULATION 1398 (2d ed. 1961).

²⁴⁷ *Id.*; Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 GEO. WASH. L. REV. 214, 245 n.97 (1959).

²⁴⁸ Wall St. J., Oct. 24, 1974, at 10, col. 2. According to the complaint, the father (in his role as a newspaper financial columnist) interviewed executives of various businesses. Father and son (who is also the editor of a financial news and investment advisory journal) allegedly made 101 purchases of securities just prior to favorable reports on those securities in the son's financial journal. Neither father nor son disclosed to sellers of the shares they purchased that a favorable column would soon appear, nor did they disclose to their newspaper and financial journal readers that they held a position in the securities. In 75% of the instances, the stocks were sold within a week after the column appeared. SEC v. Campbell, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,580 (C.D. Cal. 1972) (summary of complaint); SEC Litigation Release No. 5645 (Nov. 22, 1972) (order of preliminary injunction).

"Scalping" by investment advisers has long been illegal. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180 (1963) (investment adviser enjoined from purchasing stock shortly before publishing recommendation, then selling shortly afterwards; disclosure of practice necessary to preserve the climate of fair dealing to maintain public confidence in the securities industry and to preserve the economic health of the country). *Accord*, Kidder, Peabody & Co., SEC Securities Exchange Act Release No. 8426, [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,618 (Oct. 19, 1968) (manager of investment advisory service purchased and sold securities for his own account and accounts of his relatives shortly before executing orders for clients of the service at less favorable prices). For discussions of the *Capital Gains* case, see Note, *Stock Scalping by the Investment Adviser: Fraud or Legitimate Business Practice?* 51 CALIF. L. REV. 232 (1963); Comment, *The Regulation of Investment Advice: Subscription Advisers and Fiduciary Duties*, 63 MICH. L. REV. 1220 (1965); Note, *Investment Advisers and Disclosure of an Intent to Trade*, 71 YALE L.J. 1342 (1962). See also SECURITIES & EXCHANGE COMM'N, SPECIAL STUDY OF THE SECURITIES MARKETS, H.R. DOC. NO. 95, 88th Cong., 1st Sess., pt. 3, at 65-102 (1963).

Both the New York and American Stock Exchanges have condemned selective preferential disclosure by a broker to a few clients prior to publishing a market letter. NYSE, GUIDELINES FOR MEMBER FIRM COMMUNICATIONS WITH THE PUBLIC 5 (1970); NYSE, M.F. Circular No. 170 (Nov. 16, 1962); ASE, Info. Circular No. 51-71 (April 30, 1971). The New York Stock Exchange recently disciplined a securities analyst by barring him from employment with any member firm for eighteen months because he had disseminated selectively to an investment counseling firm an internal report on hospital management companies prior to official publication. Wall St. J., July 6, 1973, at 7, col. 1.

²⁴⁹ 15 U.S.C. § 78j(b) (1970).

²⁵⁰ 17 C.F.R. § 240.10b-5 (1975).

by financial columnists who recommend the purchase or sale of specific securities, registration under the Investment Advisers Act could be expected to have the desirable effect of permitting periodic inspection of the books and records which would have to be kept under rule 204-2.²⁵¹

It could be argued, however, that registration under the Investment Advisers Act would have a "chilling effect," be a "prior restraint," or otherwise unconstitutionally impinge upon the first amendment rights of a financial columnist. This argument was advanced by the defendant and found wanting by the Second Circuit Court of Appeals in the *Wall Street Transcript* case.²⁵² Moreover, a financial columnist recommending the purchase or sale of specific securities holds himself out as a disinterested observer; readers are entitled, at a minimum, to clear warning of any departure from this standard. The Investment Advisers Act would not impose any substantive or censorship-like restraints on a financial columnist's freedom of expression; it would only affect those few actions a financial columnist would take in recommending the purchase or sale of specific securities that would conflict with his duties to his readers.²⁵³ That, in our

²⁵¹ 17 C.F.R. § 275.204-2 (1975).

²⁵² *SEC v. Wall Street Transcript Corp.*, 422 F.2d 1371 (2d Cir.), cert. denied, 398 U.S. 958 (1970), rev'g 294 F. Supp. 298 (S.D.N.Y. 1968). The Commission sued *The Wall Street Transcript* to enforce a subpoena duces tecum requiring production of certain advertising materials and correspondence with subscribers, prospective subscribers, and suppliers of securities reports published in *The Wall Street Transcript*. In deciding that the Commission, rather than a court, was the proper body to make the initial determination as to *The Wall Street Transcript's* status under the Advisers Act, the Second Circuit Court of Appeals stated:

We do not think, however, that [the First Amendment was] what Congress had in mind when it placed "bona fide" newspapers among the exclusions from the statute's coverage. Section 202(a)(11) of the [Investment Advisers] Act lists a number of examples of persons or entities whose activities might fall within the broad definition of "investment adviser" but whose customary practices would not place them in the special, otherwise unregulated, fiduciary role for which the law established standards. Cf. *SEC v. Capital Gains Research Bureau, Inc.*, supra. The phrase "bona fide" newspapers, in the context of this list, means those publications which do not deviate from customary newspaper activities to such an extent that there is a likelihood that the wrongdoing which the [Advisers Act] was designed to prevent has occurred

. . . . What matters is whether or not a specific publication is engaged in practices which the [Investment Advisers] Act was intended to regulate, such as the offering of investment advice without revealing the possibility of personal gain to the publisher from what he reports or how he presents it. See *SEC v. Capital Gains Research Bureau, Inc.*, supra.

422 F.2d at 1377-78 (footnote omitted).

²⁵³ Section 206 would of course require disclosure of "scalping," as discussed

view, is precisely what the Investment Advisers Act was intended to accomplish.

Thus, we recommend that section 202(a)(11)(D) be amended to make clear²⁵⁴ that financial columnists who regularly recommend the purchase or sale of specific securities are required to register under and comply with the substantive requirements of the Investment Advisers Act.²⁵⁵

2. Exceptions to Registration

Section 203(a) prohibits all investment advisers from making use of the mails or any other means or instrumentality of interstate commerce in connection with their business as an investment adviser, unless registered pursuant to section 203(c). Section 203(b), however, excepts from the registration requirements of section 203(c) those investment advisers who satisfy the conditions of paragraph (1), (2), or (3). Paragraph (1) of section 203(b) excepts

any investment adviser all of whose clients are residents of the State within which such investment adviser main-

in note 248 *supra*. Moreover, the advertising restrictions in rule 206(4)-1(a), 17 C.F.R. § 275.206(4)-1(a) (1975), would apply to any written communication addressed to more than one person, which offers analyses or reports concerning securities or any other investment advisory service regarding securities.

²⁵⁴ In our view, as a matter of statutory interpretation financial columnists who recommend the purchase or sale of specific securities are already covered by the general definition of investment adviser and are not excluded from the definition by the publisher's exclusion of § 202(a)(11)(D). *E.g.*, Raymond L. Panico (SEC staff letter, Jan. 7, 1975); Sam Shulsky, BNA SEC. REG. & L. REP. No. 227, at C-3 (Nov. 14, 1973) (SEC staff letter, Oct. 2, 1973); Theodore H. Friedenberg (SEC staff letter, June 20, 1973).

²⁵⁵ It seems equally clear that any person who holds himself out as a financial analyst, financial adviser, financial counselor, or any of the other titles which are merely permutations of these, whether self-employed or employed by others, could engage in the same fraudulent activities as an investment adviser or a financial columnist and would be subject to the same policy arguments regarding the overriding public interest in registration and regulation of a financial columnist. In most instances, such quasi-investment advisers appear to hold themselves out to others as disinterested observers and thus would have analogous opportunities for self-dealing or overreaching their clients, be they public investors or corporate employers. However, some of the provisions of the Investment Advisers Act would present practical problems of application such as the performance fee restrictions in § 205 or the advertising restrictions in rule 206(4)-1, to quasi-investment advisers, for example, with corporate employers; for such persons, it might be desirable to adopt exemptive rules under § 206A which would tailor more closely the provisions of the Investment Advisers Act to the activities of the persons being regulated. Nevertheless, it seems plain that such quasi-investment advisers fall within the findings in § 201 of the Investment Advisers Act to the same extent as the more traditional investment counselor or monthly securities report writer, thereby confirming the appropriateness of their registration under the Investment Advisers Act. *Cf.* Securities Exchange Act of 1934, §§ 3(a)(30), 15 B(a), as amended, Pub. L. No. 94-29 §§ 3(6), 13, 89 Stat. 97.

tains his or its principal office and place of business, and who does not furnish advice or issue analyses or reports with respect to securities listed or admitted to unlisted trading privileges on any national securities exchange

No legislative history explains why Congress intended to exclude an "intrastate" investment adviser even though he was giving advice solely about securities traded over-the-counter. If Congress' theory was that regulation of such a person at the state rather than the federal level was more appropriate, in view of the relatively modest amount of contacts with interstate commerce, that theory breaks down in every state where there is not at least the equivalent of the Investment Advisers Act.²⁵⁶ Moreover, with the advent of NASDAQ,²⁵⁷ which is treated for many purposes as if it were a national securities exchange, it would appear that the extension of section 203(b)(1) to some securities traded over-the-counter is too broad since use of NASDAQ surely involves more than modest contacts with interstate commerce.

Accordingly, because it deprives a class of investors of protection for reasons that are no longer compelling in light of technological advances in the marketing of securities, we recommend that section 203(b)(1) be repealed entirely²⁵⁸ or, at the very least, that the reference to securities listed or admitted to unlisted trading privileges on national securities exchanges be expanded to include securities listed in NASDAQ.²⁵⁹

²⁵⁶ Further, in many states that do have some type of Investment Advisers Act, its purpose is to do no more than provide a census and the statute is unlikely to have substantive regulatory provisions.

²⁵⁷ NASDAQ is the acronym for the National Ass'n of Securities Dealers' Automated Quotations System, which began in February 1971 to provide a centralized nationwide electronic auction market system for over-the-counter securities. CCH NASD MANUAL ¶ 1653A; see NASD, *THE NASDAQ COMPANY AND THE NASDAQ MARKET* (1974); Katz, *NASD Automated Quotations System*, in *THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION* 359 (R. Mundheim & A. Fleischer, Jr. eds. 1972).

²⁵⁸ It could be argued that an investment adviser who curtails his activities so severely as to be able to rely on § 203(b)(1) may place himself in a position where the securities he can recommend that his clients purchase or sell are so unsuitable with respect to a typical investment portfolio that the investment adviser virtually breaches his fiduciary duty to render investment advice impartially and in the best interests of his clients.

²⁵⁹ But see Pass, Fuinsbert & Augur, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,070 (SEC staff letter, Oct. 30, 1974) (concerning TISE Inc.) (intrastate offerings of tax shelter securities); C. Dale McClain (SEC staff letter, Sept. 24, 1974) (concerning undisclosed client) (municipal bonds).

3. Financial and Professional Responsibility

The Investment Advisers Act lacks statutory provisions of the kind found in section 15(b)(7) of the Securities Exchange Act²⁶⁰ authorizing the Commission to establish standards for classifying investment advisers, requiring persons in any class to pass examinations and to comply with specified standards of training.²⁶¹ Similarly, section 15(c)(3) of the Securities Exchange Act²⁶² authorizes the Commission to adopt rules²⁶³ providing for "financial responsibility and related practices" of broker-dealers, including acceptance and use of customers' securities, carrying and use of customers' securities, carrying and use of customers' deposits or credit balances, and maintenance of reserves with respect to customers' deposits or credit balances.

Such authority is clearly necessary and appropriate if the Commission is to engage in meaningful regulation of the activities of investment advisers, and we recommend amendment of the Investment Advisers Act to provide authority to set financial and professional responsibility standards.

4. Self-Regulation

Moreover, the Investment Advisers Act also lacks statutory provisions similar to section 15A of the Securities Exchange Act²⁶⁴ authorizing the registration of any association of broker-dealers dedicated to the self-regulation of its members, and provisions similar to sections 15(b)(8) and (b)(9)²⁶⁵ authorizing the Commission to collect fees from and prescribe rules governing principles of trade and other matters for broker-dealers who choose not to belong to a self-regulatory organization. Again,

²⁶⁰ 15 U.S.C.A. § 78o(b)(7) (Supp., Aug. 1975).

²⁶¹ See rules 15b8-1 to -2, 17 C.F.R. §§ 240.15b8-1 to -2 (1975); 2 L. LOSS, *SECURITIES REGULATION* 1288-1343 (2d ed. 1961); 5 *id.* 3349-3406 (Supp. 1969). See generally E. WEISS, *REGISTRATION AND REGULATION OF BROKERS AND DEALERS* (1965).

²⁶² 15 U.S.C.A. § 78o(c)(3) (Supp., Aug. 1975).

²⁶³ See rules 15c3-1 to -3a, 17 C.F.R. §§ 240.15c3-1 to -3a (1975) (net capital requirements, customers' free credit balances, reserves and custody of securities); 2 L. LOSS, *SECURITIES REGULATION* 1346-55 (2d ed. 1962); 5 *id.* 3406-08 (Supp. 1969).

²⁶⁴ 15 U.S.C.A. § 78o-3(a) (Supp. Aug. 1975). See rules 15Ab-1, 15Ag-1, 15Aj-1 to -3, and 15A/2-1, 17 C.F.R. §§ 240.15Aa-1, .15Ab-1, .15Ag-1, .15Aj-1 to -3, .15A/2-1 (1975); 2 L. LOSS, *SECURITIES REGULATION* 1359-91 (2d ed. 1961); 5 *id.* 3448-3511 (Supp. 1969); White, *National Association of Securities Dealers, Inc.*, 28 GEO. WASH. L. REV. 250 (1959).

²⁶⁵ 15 U.S.C.A. §§ 78o(b)(8), (9) (Supp., Aug. 1975); see rules 15b9-1 to -2, 15b10-1 to -10, 17 C.F.R. §§ 240.15b9-1 to -2, .15b10-1 to -10 (1975). See also 5 L. LOSS, *SECURITIES REGULATION* 3434-48 (Supp. 1969).

such authority to register self-regulatory organizations is clearly necessary and appropriate to provide for meaningful self-regulation;²⁶⁶ the authority to adopt rules directly regulating those who choose not to join a self-regulatory organization with respect to matters falling generally into the category of business ethics is necessary to backstop the work done by self-regulatory organizations. We recommend amendment of the Investment Advisers Act to provide such authority.

5. Mini-Accounts²⁶⁷

a. *The SIAS Case*

In February, 1970, the Commission brought injunctive proceedings against First National City Bank (Citibank) and Merrill Lynch, Pierce, Fenner and Smith, Inc., alleging violations of the Investment Company Act and Securities Act in the operation of Citibank's Special Investment Advisory Service (SIAS).²⁶⁸ SIAS involved a customer's limited power of attorney giving Citibank investment discretion and authorizing Merrill Lynch to accept instructions from Citibank.²⁶⁹ Citibank and Merrill Lynch

²⁶⁶ Some quasi-self-regulatory organizations of investment advisers already exist, such as the Investment Counsel Association of America. Investment counselors, however, would appear to be only one part of the disparate group registered under the Investment Advisers Act, including: bank subsidiaries, insurance company subsidiaries, investment company advisers, monthly securities report writers, financial columnists, and business consultants. One would expect that, unlike § 15A under which only the NASD has registered, several self-regulatory organizations might be formed around the different constituents within this group and might propose rules of practice that are exclusively applicable to the problems of their members. See *Professional Groups Take Two Approaches to Regulation of Security Analysts*, BNA SEC. REG. & L. REP. NO. 239, at A-15 to A-16 (Feb. 13, 1974).

²⁶⁷ See generally Bines, *Regulating Discretionary Management: Broker-Dealers as Catalysts for Reform*, 16 B.C. IND. & COM. L. REV. 347 (1975); Comment, *Small Investment Advisory Services: Reclassification to Aid the Small Investor*, 5 CONN. L. REV. 639 (1973).

²⁶⁸ SEC v. First Nat'l City Bank, SEC Litigation Release No. 4534, [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 92,592 (Feb. 6, 1970). For a contemporaneous discussion of the SIAS case by a member of the Commission staff (including some comments on the reasons for its initiation), see Mostoff, *The SEC, 17(d), and Incentive Compensation*, in *INSTITUTIONAL INVESTORS IN A CHANGING ECONOMY* 317, 318-31 (M. Cohen & K. Bialkin eds. 1970).

²⁶⁹ Additionally, Citibank required a customer to have a minimum account of \$25,000, to authorize the bank to invest in different securities in a manner designed to produce long-term capital growth or income, and to permit the account to be handled as a normal brokerage account providing usual advices and confirmations by the broker-dealer. The complaint also alleged that, after the initial investments were made, all decisions by Citibank to buy or sell a security were generally applied to all persons' accounts uniformly, even though Citibank's advertising stated that Citibank would give each SIAS investor the same individualized and personalized attention and supervision as

agreed, in seeking dismissal of the injunctive proceeding, permanently to cease offering SIAS and to refrain from similar activities in the future; Citibank was permitted, however, to offer a non-discretionary investment advisory service with execution available through any broker-dealer selected from a list of at least three provided by Citibank.

b. *The Advisory Committee Report*

Because of the uncertainty caused by the SIAS case, in October, 1972, former Chairman Casey appointed an Advisory Committee on Investment Management Services for Individual Investors to assist the Commission in developing clearer policies and guidelines with respect to these so-called mini-accounts.²⁷⁰

was received by customers of its regular investment advisory service designed for a minimum account of \$200,000. SEC v. First Nat'l City Bank, SEC Litigation Release No. 4534, at 2-3 (Feb. 6, 1970). It has been reported that at the time of the Commission suit Citibank had \$35 million under management for over 1,000 SIAS clients. Everdell, *Individual Advisory Accounts and the Registration Requirements*, in FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 163-64 (R. Mundheim, A. Fleischer, Jr., & J. Schuppper eds. 1974).

The Commission's allegation in the SIAS case that providing discretionary investment management was the offer and sale of a security was not novel even in 1970. *E.g.*, SEC v. Continental Commodities Corp., 497 F.2d 516 (5th Cir. 1974); *Rochkind v. Reynolds Sec.*, 388 F. Supp. 254 (D. Md. 1975); *Marshall v. Lamson Bros.*, 368 F. Supp. 468 (D. Iowa 1974); *Berman v. Orimex Trading, Inc.*, 291 F. Supp. 701 (S.D.N.Y. 1968); *Anderson v. Francis I. duPont & Co.*, 291 F. Supp. 705 (D. Minn. 1968); *Maheu v. Reynolds & Co.*, 282 F. Supp. 423 (S.D.N.Y. 1967). *But see* *Milnarik v. M-S Commodities, Inc.*, 457 F.2d 274 (7th Cir.), *cert. denied*, 409 U.S. 887 (1972). Although the idea that a "company" for the purposes of the Investment Company Act did not have to be a formally organized entity was also not novel, even in 1970, there were some persons who were nevertheless surprised by the Commission's allegation of its applicability to the SIAS case. For Investment Company Act cases involving the concept of "company," see the cases cited in notes 90 & 96 *supra*.

Following the SIAS case, Commission staff correspondence with persons requesting interpretive advice emphasized that the Investment Company Act could be avoided only if the person offering mini-account services retained little (if any) investment discretion, or gave individualized treatment and did not mass-merchandise the investment advisory service through general advertising in the mass media. ADVISORY COMMITTEE ON INDIVIDUAL INVESTMENT, SECURITIES & EXCHANGE COMM'N, SMALL ACCOUNT INVESTMENT MANAGEMENT SERVICES: RECOMMENDATIONS FOR CLEARER GUIDELINES AND POLICIES 19, CCH FED. SEC. L. REP. NO. 465 (Jan. 1973) [hereinafter cited as ADVISORY COMMITTEE REPORT]. The offering of so-called maxi-accounts, the traditional large investor investment management service, would clearly fall within these tests and would thus be able to rely for nonregistration on § 4(2) of the Securities Act of 1933, 15 U.S.C. § 77d(2) (1970), and § 3(c)(1) of the Investment Company Act.

²⁷⁰ SEC Investment Advisers Act Release No. 341, at 1 (Oct. 12, 1972):

[T]here is a great deal of uncertainty about the applicability of the Investment Company Act of 1940 and the Securities Act of 1933 in this area. An advisory service which makes large-scale solicitations of relatively small accounts and provides substantially the same advice to clients can become functionally indistin-

After three months of deliberations,²⁷¹ the Advisory Committee submitted its report²⁷² and made six major recommendations: (1) the Investment Company Act should not be applicable to a mini-account service unless there is a pooling of clients' accounts; (2) the Securities Act should not be applicable if the offeror of a mini-account service furnishes individualized service or does not have discretion to execute portfolio transactions; (3) the Commission should promulgate guidelines for determining the applicability of the Investment Company Act and Securities Act; (4) persons offering a mini-account service should give prospective clients a written disclosure statement containing material information to aid them in determining whether to retain the services of a particular firm; (5) the Commission should adopt rules under the Investment Advisers Act covering conflicts of interest and other abuses in connection with the operation of mini-

guishable from an investment company. Representations as to individualized treatment of clients may in such a case also raise questions under the antifraud provisions of the Investment Advisers Act of 1940. On the other hand, notwithstanding some overlapping investment advice, such a service might actually provide individualized service.

Mr. Rosenblat was the Commission staff member appointed to the Advisory Committee, which also included persons associated with investment advisers, broker-dealers, and banks. See also Address by SEC Chairman Casey, Economic Club of Detroit, Sept. 18, 1972.

²⁷¹ At its first meeting, the Advisory Committee approved a memorandum of objectives which was published by the Commission to solicit comments and suggestions from interested persons, including those in the investment management business. SEC Investment Advisers Act Release No. 344 (Oct. 27, 1972). Specifically, the Advisory Committee's memorandum stated that it would: (1) advise the Commission on how mini-account services were initiated and operated; (2) determine the extent to which the mini-account services afforded individualized treatment; (3) determine the extent of conflicts of interest or other abuses presented by the service, including advertising and suitability; (4) decide whether the mini-account services raised problems with respect to broker-dealers or investment advisers; (5) review Commission and Commission staff positions on the basis of the information it obtained in response to its memorandum; (6) advise which mini-account services should be subject to the Investment Company Act and offer guidelines for making this decision; and (7) recommend appropriate guidelines for regulation under the Investment Advisers Act or the Securities Exchange Act where the Investment Company Act was not applicable. The Advisory Committee had a deadline of January 5, 1973, for concluding its considerations. ADVISORY COMMITTEE REPORT, *supra* note 269.

²⁷² ADVISORY COMMITTEE REPORT, *supra* note 269. SEC Investment Advisers Act Releases Nos. 341 (Oct. 12, 1970) and 344 (Oct. 27, 1972) are reprinted in the *Advisory Committee Report* as appendixes A and B. The Advisory Committee's factual findings are contained in ADVISORY COMMITTEE REPORT, *supra*, at 1-15. For discussions of the *Advisory Committee Report* by two of its members, see Everdell, *Individual Advisory Accounts and the Registration Requirements*, in FIFTH ANNUAL INSTITUTE ON SECURITIES REGULATION 163 (R. Mundheim, A. Fleischer, Jr., & J. Schupper eds. 1974) [hereinafter cited as Everdell Discussion]; Rosenblat, *Mini-Accounts*, in THE SEC SPEAKS AGAIN 87 (A. Sommer, Jr. & A. Levenson eds. 1973).

account services; and (6) the Commission should establish standards for professional qualifications and financial responsibility of investment advisers, and a system of self-regulation of investment advisers.²⁷³

The Advisory Committee, in considering the applicability of the Investment Company Act to mini-accounts, placed great emphasis on the differences between a mini-account client and a mutual fund shareholder: direct ownership of specified securities rather than an undivided interest in a changing portfolio of securities. The Advisory Committee departed from the Commission's historical reliance on the significance of "overlapping" investment advice²⁷⁴ and rejected the regulatory framework of the Investment Company Act in favor of promulgation of rules and guidelines under the Investment Advisers Act.²⁷⁵ With respect to the Securities Act, the *Advisory Committee*

²⁷³ The *Advisory Committee Report* made 24 separate recommendations, many of which emanated from concerns with specific conflicts of interest, from which the six major recommendations were drawn. ADVISORY COMMITTEE REPORT, *supra* note 269, at 42 (fee-splitting), 42-51 (relationships with broker-dealers), 54-55 (use of inside information). The Advisory Committee recommended that the broker-dealer exclusion in § 202(a)(11)(C) not be deemed available to a broker-dealer who actively solicited mini-account clients, and that banks, although not generally subject to the Investment Advisers Act, should voluntarily follow their *Report's* guidelines as a "safe harbor" from attack regarding non-registration under the Investment Company and Securities Acts. ADVISORY COMMITTEE REPORT, *supra* note 269, at 59-62.

²⁷⁴ *Id.* 20-22. If the securities owned by a mini-account client were not pooled or commingled with those of other clients, the mini-account client would be able to deal independently with them at any time, unlike a mutual fund shareholder who has an undivided interest in a changing portfolio of securities. This contrast has been used in other contexts to distinguish situations which might require registration under the federal securities laws. See, e.g., SEC Securities Act Release No. 4790, 1 CCH FED. SEC. L. REP. ¶¶ 1131-33 (July 13, 1965) (employee stock purchase plans); Lucky Stores, Inc., [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,903 (SEC staff letter, June 5, 1974) (dividend reinvestment plans). However, even if the *Advisory Committee Report* can be read to say that there would be no "company" merely because a mini-account service may permit a client to deal independently with his shares at any time, we believe such a mini-account service may yet be a "company" within the meaning of § 2(a)(8) of the Investment Company Act. For cases involving the expansive concept of "company," see notes 90 & 96 *supra*. See also note 279 *infra*.

²⁷⁵ ADVISORY COMMITTEE REPORT, *supra* note 269, at 22-23. But see Comment, *supra* note 267, at 664-69, 669-76; Everdell Discussion, *supra* note 272, at 169-70 (remarks of Stanley Sporkin):

I disagree. These services look like an investment company—one hundred people each buying one share through a broker and adviser is the functional equivalent of each owning 1 percent of a hundred-share lot. In addition, the merchandising and practical operation make this vehicle indistinguishable from an investment company. The investors need the same protection in both cases and the Investment Company Act will give that to them

. . . .

What we are concerned with is whether someone, claiming to act as an

Report conceded that many discretionary investment services would result in the creation of separate securities and that the solicitation of clients could be a public offering of one or more investment contracts, but concluded that no public offering should be deemed to occur if each mini-account contract was essentially different or individualized,²⁷⁶ and that the Securities Act itself should not apply where a person offered an impersonal investment service on a non-discretionary basis.²⁷⁷

c. *Recommendations Regarding Mini-Accounts*

The ALI Code, which would move away from the traditional theology of the past forty years regarding registration of

investment adviser, is merely providing services which would be available from an investment company. The law affords investors certain protections. The mere fact that the stock is put into the person's account, to me, would not determine that the operation is not an investment company, especially where overlapping is present.

²⁷⁶ ADVISORY COMMITTEE REPORT, *supra* note 269, at 23-25. The Commission recently imposed sanctions upon a registered investment adviser whose representations regarding its "individualized" service were found to be untrue and misleading. Chase Investment Services of Boston, Inc., SEC Investment Advisers Act Release No. 449 (Mar. 28, 1975); Wall St. J., April 1, 1975, at 16, col. 3. According to the Advisory Committee, the conclusion that no public offering was involved would be a logical extension of the private offering exemption. ADVISORY COMMITTEE REPORT, *supra*, at 24. *But see* Comment, *supra* note 267, at 657-64. *See also* Everdell Discussion, *supra* note 272, at 176:

I have gradually come to the conclusion, however, that advertising in this context changes the nature of the product. It isn't that advertising is reprehensible in itself or that it invites the attention of the [Commission] staff but it is in the advertising that the product is not only widely offered but explicitly and implicitly defined and determined. Since what is described and offered in an advertising campaign through the press and other media is offered to everyone, it is fair to apply the definitions of the [Securities Act of 1933] to that which everyone is offered. If the offer is limited to a simple solicitation of inquiries from those interested in individual investment management, without any description of the relationship or any claims to results, the question of whether there is a security can be determined by what the individual investment management involves.

However, the advertising for small accounts has gone well beyond such limits. Perhaps when the parties get together and the customer walks in with his money for investment, the papers which he signs or the arrangement implemented will not create an investment contract for purposes of the 1933 Act definition. But if the advertising material touts investment management services, it is investment management services which are being offered, not any particular contract. However extensive and detailed the advertising material may be, it never contains a suggestion that any substantial efforts on the part of the customer were being required for him to make money. Since the offering made by the advertisement is identical for millions of people, there is even commonality, which is the other element of the test under [SEC v. W.J.] *Howey* [Co., 328 U.S. 293 (1940)].

²⁷⁷ ADVISORY COMMITTEE REPORT, *supra* note 269, at 25; Everdell Discussion, *supra* note 272, at 172. The Advisory Committee noted that the arrangement adopted by

securities rather than issuers,²⁷⁸ provides a unique opportunity to resolve the mini-account questions.²⁷⁹ Critics of the *Advisory Committee Report* have generally raised questions about the efficacy of the Investment Advisers Act as a regulatory statute, as compared with the Investment Company Act,²⁸⁰ and about substitution of disclosure under the Investment Advisers Act for the disclosure framework of the Securities Act.²⁸¹ Especially as aug-

Citibank and Merrill Lynch in settling the SIAS case would provide an appropriate model for "a truly non-discretionary service." ADVISORY COMMITTEE REPORT, *supra* note 269, at 25.

²⁷⁸ See Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27, 33-34 (1969); ALI, FEDERAL SECURITIES CODE §§ 401-05 (Reporter's Revision of Text of Tent. Draft Nos. 1-3, Oct. 1, 1974) (registration of issuers with publicly held securities). The difficulties in preparing a coherent regulatory scheme regarding mini-accounts within existing law, statutory and judicial, is exceptionally well stated in Bines, *Regulating Discretionary Management: Broker-Dealers As Catalysts for Reform*, 16 B.C. IND. & COM. L. REV. 347, 389-90 (1975).

²⁷⁹ Although the *Advisory Committee Report* was published in January 1973, the Commission has not yet formally reacted to its recommendations. However, there have been some indications that the *Advisory Committee Report* has been actively considered by the Commission. See Commission Inquiry Concerning Bank-Sponsored Investment Services, SEC Investment Advisers Act Release No. 409, at 5-6, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,767, at 84,074 (April 30, 1974) ("The Commission expects shortly to publish for comment certain proposed positions with respect to the issues raised generally by the offering of such [mini-account] services and the recommendations of its Advisory Committee on Investment Management Services for Individual Investors."); Address by SEC Chairman Garrett, Investment Company Institute, Washington, D.C., May 15, 1974, at 11-15, summarized in [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,791, discussed in *Mutual Fund Managers Celebrate 50th Birthday*, BNA SEC. REG. & L. REP. No. 253, A-11, A-12 (May 22, 1974):

In the near future, we will announce the direction we intend to move, and will solicit comments from the public on certain of our proposed positions.

In summary, these are:

1. Where assets are managed on a discretionary basis, registration would be required under the '33 and '40 Acts if clients do not receive individualized treatment, even though the assets are not pooled (that is, investors retain all the incidents of ownership of the underlying securities)

. . . .

2. Non-discretionary services should not be treated as offering a security for purposes of either the '33 or '40 Acts, if they afford clients a meaningful basis for making their own investment decisions. Generally, this would mean that clients should receive a statement furnishing them with a reasonable basis for the adviser's recommendation so that they can make an independent judgment as to its merits.

3. Rules and guidelines under the Advisers Act, and possibly the '34 Act, need to be developed to deal with disclosure, conflicts of interest, and other investor protection problems where mini-account arrangements will not be registered under the '33 and '34 Acts. An information statement disclosing the material facts about the advisory service should be required to be transmitted to prospective clients, and other potentially dangerous practices should be prohibited or regulated.

Id. 12-14.

²⁸⁰ *E.g.*, Comment, *supra* note 267, at 669-79.

²⁸¹ *E.g.*, *id.* 676-83.

mented in the manner we have recommended above, the Investment Advisers Act would contain sufficient statutory authority to regulate persons offering mini-accounts.²⁸² Investor protection could be achieved under the Investment Advisers Act, we believe, without having to resort to imposition of the Investment Company Act.²⁸³ A continuous disclosure statement along the lines of proposed Investment Advisers Act rule

²⁸² One major problem which our formulation leaves unresolved is that not all persons who would be likely to offer mini-account services are subject to the Investment Advisers Act, e.g., banks. For a discussion of some aspects of the bank exclusion from the Investment Advisers Act, see note 95 *supra*. We can discern no reasons why the investment advisory function of banks should not be subject to the Investment Advisers Act, and we believe that the bank exclusion from the definition of investment adviser in § 202(a)(11)(A) should be removed. Because the broker-dealer exclusion in § 202(a)(11)(C) would generally be unavailable to broker-dealers who provide mini-account services (because they would charge an advisory fee and thus would meet neither the "solely incidental" nor the "no special compensation" conditions of the exclusion), there would not appear to be any reason to remove the broker-dealer exclusion. A recent Note concludes that banks are subject to regulation comparable to that governing broker-dealers, investment advisers, or investment companies, where banks offer comparable investment services. Note, *The Legality of Bank-Sponsored Investment Services*, 84 YALE L.J. 1477, 1497-1504 (1975). In particular, the Note examines the appropriate regulatory agency's ability to inspect books and records, investor protection against the entity's insolvency, and suitability of investments, all in the context of a service providing pooled execution of securities transactions, although presumably the same analysis could be made for mini-accounts and other investment services. We disagree with the analysis offered and the conclusions reached in the Note. Although this topic is certainly worthy of substantial independent consideration, based on the extended analysis developed in Lybecker, *Regulation of Bank Trust Department Investment Activities: Seven Gaps, Eight Remedies* (pts. 1-2), 90 BANKING L.J. 812 (1973); 91 *id.* 6 (1974), we believe that the fiduciary aspects of bank investment management are not now regulated in a manner comparable with similar activities of broker-dealers, investment advisers, and investment companies.

Moreover, even if the fiduciary aspects of investment management were regulated in a comparable manner for bank and non-bank investment managers, and if one were willing to hold apart as a neutral factor the enormous difference in regulatory attitude toward enforcement of violations, it would still be true that significant differences would face an aggrieved investor. First, other than rule 10b-5 (under which the aggrieved investor would have no cause of action unless he was a purchaser or seller of the securities involved in fraudulent or deceptive acts), no general antifraud provision (like § 206 of the Investment Advisers Act) would apply to a bank. Second, assuming, despite bank assertions that many of their investment services do not even involve a fiduciary relationship, that an aggrieved investor could find a suitable cause of action under state trust law, he would be remitted to an action for an accounting. Compare *Shaffer v. Chemical Bank*, [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,403 (S.D.N.Y. 1972) (class action regarding use of brokerage to attract deposits dismissed on the ground that the better remedy would be a trust accounting procedure), with *Electronic Specialty Co. v. International Controls Corp.*, 409 F.2d 937 (2d Cir. 1969) (nontendering shareholder and target company have standing to allege violations of Williams Act provisions relating to tender offers).

²⁸³ Any attempt to apply the Investment Company Act would have to be coupled with extensive exemptive relief from provisions of the Act which plainly can have no applicability if mini-accounts are to exist at all. For example, the integral concepts of disinterested directors (§§ 10 & 15) and shareholder democracy (§ 18(i)) would appear

206(4)-4²⁸⁴ would further the public policy goal of disclosing material facts about the offeror of a mini-account service without becoming entangled in the metaphysics of Securities Act short-form registration statements,²⁸⁵ post-effective amendments,²⁸⁶ rescission rights,²⁸⁷ and stringent liability for false and misleading registration statements.²⁸⁸

These investor protection objectives are consistent with the stated objectives of the ALI Code and would properly focus the regulatory effort where investor protections can be most closely tailored to the actual and potential abuses. A person offering discretionary investment management services²⁸⁹ who is registered under the Investment Advisers Act should be exempt from the registration and regulatory provisions of the Investment Company and Securities Acts with respect to that service.

IV. RECOMMENDATIONS TO REMOVE EXCLUSIONS FROM INVESTMENT COMPANY ACT-TYPE REGULATION

A. *ICC Companies*

Section 3(c)(7) of the Investment Company Act excludes from the definition of an investment company:

Any company subject to regulation under the Interstate Commerce Act, or any company whose entire out-

to have little relevance to the clients of a mini-account service. Similarly, the sales load provisions (§ 22), anti-pyramiding provisions (§ 12), and capital structure provisions (§ 18) also would appear to have little relevance to the clients of a mini-account service. The crucial sections seem to be § 17 (conflicts of interest) and § 36 (fiduciary duties), which have analogies in the Investment Advisers Act.

²⁸⁴ SEC Investment Advisers Act Release No. 442, [1974-1975 Transfer Binder] CCH FED. SEC. L. REP. ¶ 80,128 (March 5, 1975). For discussions of proposed rule 206(4)-4, see *Advisers Act Developments*, *supra* note 221, at 917; Fleischer, *Forcing Advisers to Open Up*, INSTITUTIONAL INVESTOR 95 (May, 1975).

²⁸⁵ *E.g.*, rule 145, form S-14, 17 C.F.R. §§ 230.145, 239.23 (1975); rule 430, form S-8, 17 C.F.R. §§ 230.430, 239.16b (1975).

²⁸⁶ *E.g.*, SEC Securities Act Release Nos. 5439, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,559 (Nov. 14, 1973) (annual updating of investment company prospectuses); 5305, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,998 (Sept. 21, 1972) (post-effective amendments to investment company registration statements).

²⁸⁷ Securities Act of 1933, § 12(2), 15 U.S.C. § 77l(2) (1970); *see* 3 L. LOSS, SECURITIES REGULATION 1699-1712 (2d ed. 1961); 6 *id.* 3831-34 (Supp. 1969).

²⁸⁸ Securities Act of 1933, § 11, 15 U.S.C. § 77k (1970); *see* Escott v. BarChris Constr. Co., 283 F. Supp. 643 (S.D.N.Y. 1968); 3 L. LOSS, SECURITIES REGULATION 1721-42 (2d ed. 1961); 6 *id.* 3842-56 (Supp. 1969). *See generally* A.B.A. National Institute, *The BarChris Case: Prospectus Liability*, 24 BUS. LAW. 523 (1969); Folk, *Civil Liabilities under the Federal Securities Acts: The BarChris Case* (pts. 1-2), 55 VA. L. REV. 1, 199 (1969).

²⁸⁹ A discretionary investment management arrangement regarding any type of property, not just conventional securities, could be regulated through the Investment

standing capital stock is owned or controlled by such a company: *Provided*, That the assets of the controlled company consist substantially of securities issued by companies which are subject to regulation under the Interstate Commerce Act.

At the time the Act was proposed carrier-investment companies were limited to companies holding securities of carrier companies.²⁹⁰ Consequently, when the exclusion was suggested by the American Association of Railroads as a "clarifying" amendment to the Senate version of the 1940 bill, it was readily accepted both by the subcommittee and by the SEC.²⁹¹ The subsequent evolution of the carrier-investment company, and the ICC's generally ineffective protection of substantive rights of investors in such companies, together with the narrow area of overlapping ICC-SEC interest and of possible conflict, are compelling evidence of the urgent necessity for repeal of section 3(c)(7).

The scope of section 3(c)(7)'s exclusion for carrier-investment companies is conditioned on the jurisdiction of the ICC which, in turn, is determined by sections 5(2) and 5(3) of

Advisers Act. Indeed, if the definition of investment adviser were revised also to include a reference to "securities or property," the Investment Advisers Act would have broad applicability to all persons giving financial advice, whatever mix of securities and property they chose to specialize in. One influential member of Congress has suggested that he would favor this approach. Remarks of John E. Moss, Chairman, House Subcomm. on Commerce and Finance of the Comm. on Interstate and Foreign Commerce, Sacramento Chapter, International Association of Financial Planners, Inc., Nov. 1, 1974, at 2-3.

²⁹⁰ See SPECIAL STAFF OF THE SENATE COMM. ON COMMERCE, 92D CONG., 2D SESS., THE PENN CENTRAL AND OTHER RAILROADS 424-26 (Comm. print 1972) [hereinafter cited as SPECIAL STAFF REPORT]. For various reasons, railroad holding companies were popular vehicles for the control of operating railroads. See STAFF OF THE SPECIAL SUBCOMM. ON INVESTIGATIONS OF THE HOUSE COMM. ON INTERSTATE AND FOREIGN COMMERCE, 92D CONG., 1ST SESS., INADEQUACIES OF PROTECTIONS FOR INVESTORS IN PENN CENTRAL AND OTHER ICC-REGULATED COMPANIES (Subcomm. print 1971) [hereinafter cited as STUDY ON INADEQUACIES]. Further, until the early 1960's the ICC policy stated in the 1913 New Haven Railroad investigation was maintained: "Every interstate railroad should be prohibited from expending money or incurring liability or acquiring property not in the operation of its railroad or in the legitimate improvement, extension, or development of that railroad." The New England Investigation, 27 I.C.C. 560, 616 (1913). Since the early 1960's, the ICC has abstained from actively regulating the non-carrier investments of holding companies, with the consequent development of diversified carrier-investment companies.

²⁹¹ *Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency*, 76th Cong., 3d Sess. 776-77 (1940). Originally, it was intended that railway holding corporations be dealt with under § 3(b)(2). *Id.* 177. See generally Alleghany Corp., SEC Investment Company Act Release No. 6168 (Aug. 21, 1970), reprinted in *Hearing on the Penn Central Transportation Company Before the Special Subcomm. on Investigations of the House Comm. on Interstate and Foreign Commerce: Adequacy of Investor Protection*, 91st Cong., 2d Sess. 62 (1971) [hereinafter cited as *Hearings on Inadequacies*].

the Interstate Commerce Act.²⁹² Because control of two or more carriers is sufficient to trigger ICC jurisdiction over "a person which is not a carrier," an investment company which, using a small part of its assets, exercises such control is excluded from the Investment Company Act.²⁹³ Indeed, the Pennsylvania Com-

²⁹² 49 U.S.C. §§ 5(2), 5(3) (1970). Section 5(2) provides, in pertinent part:

(a) It shall be lawful, with the approval and authorization of the [ICC] . . . (i) . . . , for a person which is not a carrier to acquire control of two or more carriers through ownership of their stock or otherwise; or for a person which is not a carrier and which has control of one or more carriers to acquire control of another carrier . . .

Section 5(3) then provides:

Whenever a person which is not a carrier is authorized, by an order entered under paragraph (2) of this section to acquire control of any carrier . . . such person thereafter shall . . . be considered as a carrier subject to such of the following provisions as are applicable to any carrier involved in such acquisition of control: Sections 20(1) to (10), 304(a)(1) and (2), 320 and 913 [requirements regarding reporting] . . . and sections 20a(2) to (11), and 314 [requirements relating to the issuance of securities] of this title . . .

Any investment company that controls two or more carriers is "subject to regulation under the Interstate Commerce Act" and is automatically excluded from the Investment Company Act regardless of the percentage of its assets consisting of carrier securities. Thus the proviso to § 3(c)(7) of the Investment Company Act is readily evaded. See STUDY ON INADEQUACIES, *supra* note 290, at 33-34.

²⁹³ See note 292 *supra*. The Alleghany Corporation is a leading example of a company that has drifted in and out of the class of investment companies by virtue of its varying substantial interests in railroads and investment securities. Alleghany registered in 1940 as a closed-end, non-diversified management investment company under the Investment Company Act. In 1945, Alleghany acquired control of the Chesapeake & Ohio Railway Company and subsequently received an order from the Commission terminating its registration under the Investment Company Act. Alleghany Corp., SEC Investment Company Act Release No. 809, [1945-1947 Transfer Binder] CCH FED. SEC. L. REP. ¶ 75,575 (Oct. 6, 1945) (order terminating registration pursuant to § 8(f)). Between 1945 and 1953, however, Alleghany disposed of the bulk of its C & O stock, and acquired a controlling block of the stock of Investors Diversified Services, a registered investment company. The ICC challenged Alleghany's ICC registration in 1954, and Alleghany proposed to acquire control of the New York Central Railroad Company. The SEC also wished to consider Alleghany's status, SEC Investment Company Act Release No. 1990 (July 7, 1954) (notice and order for hearing), but postponed its proceeding and intervened in the ICC proceedings to argue that Alleghany should be registered under the Investment Company Act. (During the pendency of the proceedings, Alleghany did register as an investment company.)

The ICC determined to retain jurisdiction over Alleghany; its decision was appealed, in effect, by minority common stockholders of Alleghany who commenced an action to enjoin enforcement of the ICC orders. *Breswick & Co. v. United States*, 134 F. Supp. 132 (S.D.N.Y. 1955) (temporary injunction), 138 F. Supp. 123 (S.D.N.Y. 1955) (permanent injunction). On appeal to the Supreme Court, the Commission argued that the exclusion in § 3(c)(7) should not be available unless a company is actually regulated by the ICC, not merely subject to its regulation. The Supreme Court sustained ICC jurisdiction over Alleghany. *Alleghany Corp. v. Breswick & Co.*, 353 U.S. 151 (1957); *cf. Schwartz v. Alleghany Corp.*, 282 F. Supp. 161 (S.D.N.Y. 1968) (stockholder derivative actions challenging 1954 ICC order); *Schwartz v. Bowman*, 244 F. Supp. 51 (S.D.N.Y. 1965), *aff'd mem. sub nom. Annenberg v. Alleghany Corp.*, 360 F.2d 211 (2d Cir.), *cert. denied*, 385 U.S. 921 (1966); *Schwartz v. Bowman*, 156 F. Supp. 361 (S.D.N.Y. 1957), *appeal dismissed sub*

pany, a 100% Penn Central owned company through which the parent conducted its diversified investments, was excluded from Investment Company Act coverage because, using at most forty-four percent of its assets, it controlled several carriers.²⁹⁴ This anomaly, which is limited only by the doctrine that the ICC must be actively regulating the carrier-investment company,²⁹⁵ was considered in the 1959 congressional hearings on legislation to amend the Investment Company Act.²⁹⁶ However, no action was taken on the problem.

The collapse of the Penn Central in 1970²⁹⁷ brought renewed congressional attention to the section 3(c)(7) exclusion.²⁹⁸ Cognizant of the enormous small-investor interests that were

nom. Schwartz v. Eaton, 264 F.2d 195 (2d Cir. 1959) (stockholder derivative action challenging 1945 ICC order). The Commission's position on the scope of § 3(c)(7) was, however, ultimately considered on the merits and approved. Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965) (dormant water carrier must be subject to active regulation by the ICC to rely on § 3(c)(7)).

With the 1968 merger of the New York Central and Pennsylvania Railroads, Allegheny no longer controlled a railroad and once again registered with the Commission as a closed-end, non-diversified management company. SEC Investment Company Act Release No. 5503 (Oct. 3, 1968) (notice of filing of application). Subsequently, Allegheny acquired control of Jones Motor Co., a motor carrier, and again filed an application for deregistration. SEC Investment Company Act Release Nos. 6117 (July 16, 1970) (notice of filing); 6168 (Aug. 21, 1970) (order of deregistration pursuant to § 8(f)). See generally SEC Division of Corporate Regulation, Memorandum on the Possible Dual Regulatory Status of Investment Company—Carriers (Dec. 4, 1970), reprinted in *Hearing on Inadequacies*, *supra* note 291, at 218.

²⁹⁴ *Hearings on Inadequacies*, *supra* note 291, at 31.

²⁹⁵ Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965).

²⁹⁶ In 1959, SEC Chairman Gadsby testified in support of amendments to § 3(c)(7) (then § 3(c)(9)) and of addition of new § 6(f), which would have subjected the investment activities of ICC companies to the Investment Company Act and the carrier and related activities to the Interstate Commerce Act. H.R. 2481, 86th Cong., 1st Sess. § 7 (1959); *Hearings on H.R. 2481 Before a Subcomm. of the House Comm. on Interstate and Foreign Commerce*, 86th Cong., 1st Sess. 407-17 (1959). The amendments were deleted by the full Committee on Interstate and Foreign Commerce because "[i]t appears that this matter needs continuing study." H.R. REP. NO. 2178, 86th Cong., 2d Sess. 15 (1960). The parallel Senate bill, S. 1181, also contained the proposed amendments, but the amendments were deleted by the full Senate Committee on Banking and Currency in reporting out S. 3772, a "clean" bill. S. REP. NO. 1759, 86th Cong., 2d Sess. 2 (1960). See Meeker, *Current Proposals to Amend the Federal Securities Laws*, 37 U. DET. L.J. 335, 350-51 (1960). It is not entirely clear why the Commission did not recommend that the exclusion for ICC companies be modified or removed in 1966. See PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 328.

²⁹⁷ See generally J. DAUGHEN & P. BINZEN, *THE WRECK OF THE PENN CENTRAL* (1973).

²⁹⁸ In the House, the Special Subcommittee on Investigations of the Committee on Interstate and Foreign Commerce commenced hearings in 1970. *Hearings on Inadequacies*, *supra* note 291. The staff, extremely critical of the ICC's regulation of carrier-investment companies, listed eight provisions of the Investment Company Act which an SEC regulated Pennsylvania Company would have violated:

If the Investment Company Act had been determined to be applicable to the

involved,²⁹⁹ and that the unregulated Pennsylvania Company lay at the heart of the cash-flow problem that led to the Penn Central bankruptcy,³⁰⁰ Congress studied whether ICC regulation of securities issues and of corporate reporting provided the necessary prophylaxis for investors. Subsequently, several legislative

Pennsylvania Company, all of the following prohibitions of the Act would have been specifically violated:

1. transactions between affiliates without prior approval of the SEC, especially transactions involving the transfer of assets;
2. excessive management compensation;
3. improper allocation of expenses between parent and subsidiary company;
4. loans to a parent holding company by a subsidiary;
5. guaranty by a subsidiary of loans made to the parent holding company by a third party;
6. sale of securities without prior approval of the SEC;
7. issue of senior securities such as preferred stock; and
8. issue of excessive debt.

Needless to say, each and every one of these prohibitions was violated, but the activity was not unlawful because the Investment Company Act was determined to be not applicable. The Investment Company Act was passed to prevent exactly the abuses witnessed in the Penn Central situation. In retrospect, it must be concluded that the regulation of the ICC has been woefully inadequate with consequent injury to investors and to the traveling public.

STUDY ON INADEQUACIES, *supra* note 290, at 36. Providing a side-by-side comparison of ICC and SEC regulation of such companies, the committee staff recommended that § 3(c)(7) be repealed. *Id.* 5. In 1972, the Subcommittee received the SEC staff report on the Penn Central collapse. SECURITIES & EXCHANGE COMM'N STAFF, REPORT ON THE FINANCIAL COLLAPSE OF THE PENN CENTRAL COMPANY (Subcomm. print 1972) [hereinafter cited as SEC REPORT ON PENN CENTRAL]. The Report studied in depth the lack of adequate corporate disclosure, the suspicious accounting procedures, the dubious conduct of senior management, and the ineffective control exercised by the board of directors. It concluded by attacking the Commission's recommendation that § 3(c)(7) be repealed. *Id.* 359-66. Cf. STAFF OF HOUSE COMM. ON BANKING AND CURRENCY, 92D CONG., 1ST SESS., THE PENN CENTRAL FAILURE AND THE ROLE OF FINANCIAL INSTITUTIONS (Comm. print 1972) [hereinafter cited as FINANCIAL INSTITUTIONS AND PENN CENTRAL].

The Senate efforts extended to forming a special staff to review the Penn Central. The staff report was transmitted by Senator Hartke, of the Subcommittee on Surface Transportation, to Chairman Magnuson late in 1972. SPECIAL STAFF REPORT, *supra* note 290. While criticizing the ICC's failure to exert regulatory control over investments by non-carrier holding companies, the staff recommended not that the regulatory power be shifted to the SEC, but rather that the ICC use its existing statutory power more effectively to impose control over these activities. *Id.* 422-30.

²⁹⁹ At the time of the failure, 100,000 stockholders each held fewer than 100 shares of Penn Central. STUDY ON INADEQUACIES, *supra* note 290, at 6-7.

³⁰⁰ The Pennsylvania Company made cash investments of at least \$144 million in four principal subsidiaries: Arvida Corp., Buckeye Pipe Line Co., Great Southwest Corp., and Macco Corp. (all but Buckeye were real estate companies). Assuming an additional market interest cost of \$51 million for additional cash borrowed to finance this diversification, at least \$195 million was tied up by the Company. In view of the unsuccessful attempts in 1970 to obtain government guarantees on \$200 million in loans and to float \$100 million in bonds, the large sums tied up in the Pennsylvania Co. became especially significant. FINANCIAL INSTITUTIONS AND PENN CENTRAL, *supra* note 298, at 23-148; SEC REPORT ON PENN CENTRAL, *supra* note 298, at 5.

proposals have been considered; in the House-passed version of the Rail Reorganization Act of 1973 the exclusion was eliminated for railroads.³⁰¹

Despite the evolution of carrier-investment companies, and the Allegheny and Penn Central experiences, the exclusion has survived. The ICC's inadequate protection of investors is fundamentally the result of its statutory mandate.³⁰² In carrying out its responsibilities, the ICC has developed a policy of abstention from the regulation of non-carrier investments by carriers and by carrier holding companies, providing an unwarranted gap in the regulation of investment companies.³⁰³ The SEC often has proposed the repeal of section 3(c)(7) and, realizing the current lack of investor protection, the ICC has supported that action.³⁰⁴ In view of the above, we urge that section 3(c)(7) be deleted from the ALI Code.

B. Oil and Gas Programs

Beginning in 1966 in its *Report on the Public Policy Implications of Investment Company Growth*,³⁰⁵ the Commission has recommended extreme curtailment of the scope of section 3(c)(9), which excludes from the definition of investment company:

Any person substantially all of whose business consists

³⁰¹ Bills calling for the repeal of § 3(c)(7) were introduced by Representative Staggers in two successive Congresses: H.R. 12128, 92d Cong., 1st Sess. (1971), was never reported out of Committee; H.R. 9810, 93d Cong., 1st Sess. (1973), was subsequently dropped in favor of the provision in the Rail Reorganization Act. See SEC REPORT ON PENN CENTRAL, *supra* note 298, at 338-66.

Rather than insisting upon the complete repeal of § 3(c)(7), as in H.R. 9810, Representative Staggers finally supported a partial repeal limited to rail carriers. H.R. 9142, 93d Cong., 1st Sess. (1973) (The Rail Reorganization Act of 1973); see 119 CONG. REC. 36343 (1973) (remarks of Representative Staggers). See also 119 CONG. REC. 36381 (1973). Although this bill passed the House, the version introduced for consideration in the Senate did not include even the partial repeal. 119 CONG. REC. 41341 (1973).

Subsequently, yet another attempt to repeal § 3(c)(7) was foiled by the Senate Committee on Commerce. S. 3356, 93d Cong., 2d Sess. (1974); see *Hearings on S. 3356 Before the Senate Comm. on Commerce*, 93d Cong., 2d Sess. 24-29, 73-84 (1974).

³⁰² See generally STUDY ON INADEQUACIES, *supra* note 290, at 3. The purpose of ICC regulation is to insure the financial integrity of carriers. The thrust of SEC regulation, on the other hand, is to protect investors. This disparity of purposes also underlies the tension between bank and insurance company regulators and the SEC regarding investment services offered by banks and insurance companies. See text accompanying notes 82-109, and 110-12 *supra*.

³⁰³ SPECIAL STAFF REPORT, *supra* note 290, at 424-26.

³⁰⁴ Letter from George M. Stafford, Chairman, Interstate Commerce Commission, to Representative Harley O. Staggers, April 10, 1972, in SEC REPORT ON PENN CENTRAL, *supra* note 298, at 367, 370.

³⁰⁵ PUBLIC POLICY IMPLICATIONS, *supra* note 8, at 329.

of owning or holding oil, gas, or other mineral royalties or leases, or fractional interests therein, or certificates of interest or participation in or investment contracts relative to such royalties, leases, or fractional interests.

In the Commission's 1967 draft of the mutual fund legislation, the exclusion in section 3(c)(9) would have been narrowed in a manner similar to that—both proposed and passed—regarding section 3(c)(5) (factoring, discounting, real estate, and mortgages) by making section 3(c)(9) unavailable where the oil and gas program issued redeemable securities, face-amount certificates, or periodic payment plan certificates.³⁰⁶ The Senate passed a bill in the Ninety-first Congress containing such a provision,³⁰⁷ but the House did not;³⁰⁸ the Conference Committee determined to drop the oil and gas provision based on an agreement between the Commission and representatives of the oil and gas industry to draft legislation modeled after the Investment Company Act but tailored to fit the practices and prob-

³⁰⁶ S. 1659, 90th Cong., 1st Sess. § 3(b)(5) (1967). However, a floor amendment deleted this provision from the bill ultimately reported out of committee. The amended bill died in the 90th Congress when, the Senate having passed the bill, the House took no action. 114 CONG. REC. 23539-41 (1968), *amending* S. 3724, 90th Cong., 1st Sess. § 3(b)(5) (1968); S. REP. NO. 1351, 90th Cong., 2d Sess. 36 (1968).

³⁰⁷ S. 2224, 91st Cong., 1st Sess. § 3(b)(5) (1969); S. REP. NO. 184, 91st Cong., 1st Sess. (1969). The amendment to § 3(c)(9) would not have become effective until eighteen months after passage of the bill to give the Commission and the oil and gas industry time to work out a scheme for regulation under the Investment Company Act through use of the Commission's exemptive authority in § 6(c). 115 CONG. REC. 13694-97 (1969) (Senate floor debate on S. 2224).

³⁰⁸ Oil and gas industry witnesses suggested that no scheme of regulation through exemptive rules under the Investment Company Act would properly accommodate their present operating structure, which was carefully tailored to receive the most favorable treatment under the *Internal Revenue Code*. The Commission then offered a compromise that would have placed limitations on sales by oil and gas programs to unsophisticated investors of limited means. *Hearings on H.R. 11995, S. 2224, H.R. 13754, and H.R. 14737 Before the Subcomm. on Commerce and Finance of the House Comm. on Interstate and Foreign Commerce*, 91st Cong., 1st Sess., pt. 1, at 180, pt. 2, at 873-74, 936-52 (1969). The House, however, determined not to amend § 3(c)(9). H. R. REP. NO. 1382, 91st Cong., 2d Sess. 11-12 (1970).

In light of the industry arguments and the position taken by the commission in its testimony, your committee determined not to make any change in the existing exemption [*sic*] for oil and gas funds. At the same time, your committee recognizes the need for protection of investors in this area. Your committee has reached this decision only because of the assurances of the Commission and industry representatives that they will work diligently and expeditiously toward the goal of recommending an effective scheme for providing investors protection in this area and that those recommendations will be available to the Congress before 18 months after the enactment of this mutual fund legislation.

lems of oil and gas programs.³⁰⁹ In June 1972, the Commission submitted the Oil and Gas Investment Act of 1972.³¹⁰

Although the momentum generated by the mutual fund legislation has not carried the Oil and Gas Bill successfully through to passage in a subsequent Congress, the abuses that preceded its submission do not appear to have abated, at least in terms of continuing litigation over activities of the late 1960's and early 1970's.³¹¹ Because of the serious investor protection problems that still remain in this area,³¹² we recommend that section 3(c)(9) be repealed or, at least, that Professors Loss and Brudney and the ALI consider including the Oil and Gas Bill in the ALI Code.

C. *Real Estate and Other Tax Shelter Vehicles; REITs*

Investment Company Act section 3(c)(5) excludes from the definition of investment company:

Any person who is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates, and who is primarily engaged in one or more of the following businesses: . . . (C) purchasing or other-

³⁰⁹ The conference substitute follows the House version but with the firm understanding that representatives of the oil and gas industry will cooperate with [the Commission], in working out a reasonable regulatory statute consistent with the need for protection of investors in this area. Such proposal will be submitted to the Congress within eighteen months from the passage of this legislation. If, however, the Commission fails to receive prompt cooperation from the oil and gas industry on this matter, it is understood by the conferees that the Commission will submit early in the next Congress appropriate legislation to provide necessary investor protection in this area.

H.R. REP. NO. 1631, 91st Cong., 2d Sess. 27 (1970).

³¹⁰ Oil and Gas Investment Act of 1972, H.R. 17082, S. 3884, 92d Cong., 2d Sess. (1972). The proposed legislation was resubmitted, but not acted upon, in the Ninety-third Congress as H.R. 6821 and S. 1050, 93d Cong., 1st Sess. (1973), and has not yet been resubmitted in the Ninety-fourth Congress. For contemporaneous discussions of the Oil and Gas Bill, see sources cited in note 157 *supra*.

³¹¹ E.g., Egan, *13 Indicted in Swindle of Celebrities*, Wash. Post, Dec. 13, 1974, at D8, col. 1; Lawson, *Otis Chandler Wins Dismissal of Charges in SEC Suit Alleging Geotek Fraud Role*, Wall St. J., Mar. 18, 1975, at 15, col. 2; McClintick, *Sharing the Blame? Recent Fraud Cases Leave Professionals Vulnerable to Charges*, Wall St. J., July 7, 1975, at 1, col. 1; McClintick, *The Big Write-Off, Rich Investors' Losses in New "Ponzi" Scheme Could Hit \$100 Million*, Wall St. J., June 26, 1974, at 1, col. 1; Penn, *Promoter's Fall*, Wall St. J., Aug. 11, 1975, at 1, col. 1.

³¹² The attempts made by the NASD and Midwest Securities Commissioners, discussed at note 323 *infra*, are welcomed from the standpoint of increased investor protection, but do not, in our view, resolve all of the problems adequately. See text accompanying notes 323-28 *infra*.

wise acquiring mortgages and other liens on and interests in real estate.

Thus, despite their striking resemblance to investment companies,³¹³ real estate syndications³¹⁴ and real estate investment trusts (REITs)³¹⁵ whose portfolios are invested in securities have proceeded, in reliance on section 3(c)(5)(C), to sell interests in their portfolios to the general public without registration under the Investment Company Act.³¹⁶

There was a marked increase in the sale³¹⁷ of real estate

³¹³ See note 315 *infra*.

³¹⁴ For purposes of this Article, all tax shelter investments other than oil and gas programs will be lumped together with real estate syndications because the analyses, arguments, and conclusions we present with respect to each individual type appear to apply equally to all. All are operated by external investment managers; investors are given little, if any, opportunity to review or control management decisions. Endemic to externalized management are potential overreaching, conflicts of interest, and excessive compensation. For descriptions of different types of tax shelter investments, see R. HAFT, *TAX SHELTERED INVESTMENTS* (1973); P. REID & G. SIMONS, *CORPORATE AND EXECUTIVE TAX SHELTERED INVESTMENTS* (1972).

³¹⁵ See generally OFFICE OF ECONOMIC RESEARCH, SECURITIES & EXCHANGE COMM'N, *REAL ESTATE INVESTMENT TRUSTS: A BACKGROUND ANALYSIS AND RECENT INDUSTRY DEVELOPMENTS 1961-1974* (1975). A discussion of the complex nature of the REIT is outside the scope of this Article, but an REIT can be described generally as a mutual fund that invests in real estate, either fee interests or mortgage interests. For a thorough discussion which contrasts the federal income tax restraints on REITs with the Investment Company Act regulatory structure, see Carroll, *Tax Policy for the Real Estate Investment Trusts*, 28 TAX L. REV. 299 (1973). To obtain tax treatment analogous to that enjoyed by a mutual fund under Subchapter M of the *Internal Revenue Code*, an REIT must satisfy similar conditions, including: (1) be a bona fide trust, managed by trustees, with at least 100 shareholders and issue transferable interests; (2) hold property as a passive investment, not for sale to a customer; (3) distribute to its shareholders at least 90% of its ordinary income, 75% of which must be derived from rents, interest on mortgages, and gains from real property; (4) be managed by an independent contractor; and (5) not derive any income from rendering services. INT. REV. CODE OF 1954, §§ 856-57. The first REITs primarily made equity investment in fee interests in real estate; those underwritten in the late 1960's were principally mortgage-oriented. See Robertson, *How the Bankers Got Trapped in the REIT Disaster*, FORTUNE, March, 1975, at 113.

In view of the many recent discussions of the problems which presently beset the REIT industry, we will not also extensively review alleged abuses, conflicts of interest, and super-charged capital structures. See, e.g., Gumpert & Starr, *Too Much Too Soon, How 2 Realty Trusts Gave Bankers Big Gains—And Then Big Losses*, WALL ST. J., Mar. 14, 1975, at 1, col. 6; Address by SEC Commissioner A.A. Sommer, Jr., National Association of Real Estate Investment Trusts Annual Accounting and Tax Conference, Bermuda, June 5, 1975.

³¹⁶ An unusual example of a venture outside the exclusion provided by § 3(c)(5)(C) is a limited partnership formed solely to invest in other limited partnerships formed to invest in government-sponsored housing programs. For a discussion of the circumstances under which the Commission staff would take a no-action position with respect to this and similar ventures, see SEC Investment Company Act Release No. 8456, 4 CCH FED. SEC. L. REP. ¶ 47,357 (Aug. 9, 1974). For a recent discussion of these two-tier limited partnerships see Cohen & Hacker, *supra* note 51, at 486-93.

³¹⁷ For example, during the period 1971-72, registration statements were filed for oil

syndications, REITs, and other tax shelter securities during the 1960's and 1970's. A corresponding increased concern with investor protection in this area culminated in 1972 with the SEC's appointment of a Real Estate Advisory Committee and with the publication of that Committee's report.³¹⁸ The Real Estate Advisory Committee ultimately recommended that the Investment Company Act not be extended to tax shelters, chiefly because of its apparent belief that section 17 of that Act would have imposed an unreasonable restraint on the industry. Nevertheless, the Committee was concerned that interests in real estate syndications be able to be offered on a national level, through use of a single prospectus that would be delivered to the public through participating NASD members.³¹⁹ The Committee concluded:

[I]f the [state and federal] regulatory agencies are unable to achieve uniformity within a reasonable period of time, the [Real Estate Advisory] Committee would favor federal legislation that would increase the regulatory power of the Commission and permit the sale of real estate securities on a national basis only after the offering satisfied the requirements of the Commission.³²⁰

With respect to the abuses³²¹ in real estate syndications, the Real Estate Advisory Committee further concluded that

the proper investor protection can best be achieved by the investor being able to make an informed investment decision based on full informative, understandable and

and gas programs, real estate, and other more exotic tax shelters totaling slightly less than \$4.8 billion; registration statements regarding REITs totaled slightly less than \$4 billion. NASD News, Aug., 1973, at 4.

³¹⁸ REAL ESTATE REPORT, *supra* note 51. A summary of the Committee's recommendations is printed in [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,265 (Oct. 12, 1972). For contemporaneous discussions of the *Real Estate Report*, see Address by SEC Chairman Casey, National Association of Real Estate Boards, Honolulu, Hawaii, Nov. 13, 1972; *The Dickey Report on Syndications*, 8 REAL PROPERTY, PROBATE & TRUST L.J. 439 (1973); Comment, *Regulation of Real Estate Syndications: An Overview*, 49 WASH. L. REV. 137 (1973).

³¹⁹ REAL ESTATE REPORT, *supra* note 51, at 13-15, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,265, at 82,772-73 (Oct. 12, 1972).

³²⁰ *Id.* In the more detailed discussion that followed its recommendations, the Real Estate Advisory Committee suggested a period of one year as being a reasonable time in which to achieve uniformity. *Id.* 34. But see Comment, *Condominium Regulation: Beyond Disclosure*, 123 U. PA. L. REV. 639, 665-69 (1975) (disclosure has failed to solve problems related to abuses in real estate offerings).

³²¹ For the Real Estate Advisory Committee's views of actual or potential abuses, see REAL ESTATE REPORT, *supra* note 51, at 35-50 (sales literature, conflicts of interest, and compensation).

uniform economic disclosures in real estate security offerings If, however, improved disclosure and enforcement does not achieve this end, a regulatory approach, perhaps one similar to the Oil and Gas Investment Bill of 1972 may be necessary.³²²

In our view, the Real Estate Advisory Committee was partly right in both conclusions. With respect to disclosure requirements, there is a great difference between "stickering" a prospectus to satisfy unusual disclosure requirements in a particular state and having to write different registration statements for different states that have different substantive guidelines for the same type of tax shelters.³²³ Further, just as section 24(d) of the

³²² *Id.* 4 (footnote omitted). Other commentators have concluded that an Investment Company Act-type approach may be warranted. Dickey & Thorpe, *Federal Security Regulation of Condominium Offerings*, 19 N.Y.L.F. 473, 491 n.79 (1974); Shipman, *Foreword to Securities Symposium*, 35 OHIO ST. L.J. 251, 253 (1974); Cohen & Hacker, *supra* note 51, at 493-98.

³²³ At least three different regulatory patterns have been formulated. California has adopted the Real Estate Syndicate Act. CAL. BUS. & PROF. CODE §§ 10250 *et seq.* (West Supp. 1974); 10 CAL. ADMIN. CODE §§ 260.140.110.1 *et seq.* (West Supp. 1974). Such securities may be sold to no more than 100 investors. CAL. BUS. & PROF. CODE § 10251(a) (West Supp. 1974). Other offerings are subject to the California Corporate Securities Law. CAL. CORP. CODE § 25100(e) (West Supp. 1974); 10 CAL. ADMIN. CODE §§ 260.140 *et seq.* (West Supp. 1974).

California provides minimum standards for suitability, compensation, conflicts of interest, and self-dealing. 10 CAL. ADMIN. CODE §§ 260.140.110.1 *et seq.* (West Supp. 1974). See Van Camp, *Securities Regulation of Real Estate Investments: The California Model*, 35 OHIO ST. L.J. 309 (1974); Van Camp, *Living with Tax Shelters in California: A Discussion of the New California Real Estate Syndication Rules*, 7 U.S.F.L. REV. 403 (1973). For a thorough discussion of suitability standards under the California rules, see Hall, *Investor Suitability Standards in Real Estate Syndication: California's Procrustean Bed Approach*, 63 CALIF. L. REV. 471 (1975).

Besides the California scheme, the Midwest Securities Commissioners Association has adopted a Statement of Policy regarding real estate programs and regarding publicly offered cattle feeding programs. 1 BLUE SKY L. REP. ¶¶ 4811, 4821 (1975). The Midwest Commissioners' Statement of Policy for real estate programs contains provisions regarding: (1) requirements for sponsors; (2) suitability; (3) fees, compensation, and expenses; (4) conflicts of interest; (5) blind pools; (6) rights and obligations of participants; (7) disclosure; and (8) miscellaneous subjects. The California rules and Midwest Guidelines are compared to the NASD's proposed rules discussed below in REAL ESTATE REPORT, *supra* note 51, at 34-35.

Finally, in May 1972 the NASD proposed tax shelter rules as amendments to Art. III, § 33 of the Rules of Fair Practice. CCH NASD MANUAL ¶¶ 2001-2401. The proposed rules were divided into eight categories: (1) general requirements of sponsors and requirements concerning subscriptions, assessments, reinvestments of revenue, and liquidations; (2) rights of participants; (3) conflicts of interest; (4) suitability; (5) organization and offering expenses; (6) sponsor's compensation; (7) periodic reports by sponsors; and (8) sales literature. In July, 1973, the Commission invited public comment on the NASD's proposed tax shelter rules, and posed three policy questions for comment: (1) whether the scope of the NASD's proposed rules is supported by or conflicts with federal regulatory authority under the Securities Act and the Securities Exchange Act; (2) whether

Investment Company Act was required for the effective regulation of investment companies, federal preemption of the disclosure process is required to remove certain exemptions from the registration provisions of the Securities Act that are presently available to real estate syndications.³²⁴

It is becoming increasingly clear that mere disclosure of overreaching, conflicts of interest, and excessive compensation does not provide adequate regulation of tax shelter vehicles. Nor is it wise to rely on broad antifraud rules or fraud-oriented en-

there is a need for development of a federal legislative program to bring issuer-oriented regulation under the Commission's regulatory umbrella; and (3) whether the NASD should proceed to implement immediately those of its proposed tax shelter rules which fall into its traditional self-regulatory function. SEC Securities Exchange Act Release No. 10260, [1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,417 (July 2, 1973). On May 6, 1974, the Commission's Division of Market Regulation informed the NASD that the Commission had concluded that it would welcome prompt submission by the NASD of rules dealing with organization and offering expenses (e.g., underwriter compensation), suitability, and the content of advertising and sales literature. NASD, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,810 (SEC staff letter, May 6, 1974). The letter went on to encourage the NASD to consider whether those of its rules which were issuer-oriented—and should not be applied to sponsors, issuers, and others who were not members (or affiliated with members) of the NASD—could, nevertheless, be useful as general guidelines of suitability where they were not directly applicable; it also announced that the Commission had authorized its staff to prepare draft legislation for its consideration.

Because there are at least three tax shelter regulatory approaches, a proposed tax shelter deal tailored to satisfy one approach may be sold only in that state, or in states with substantially similar structural and operational rules and guidelines. It is also possible that the NASD rules would permit a deal to be sold by NASD members, but the state would not allow the prospectus to be disseminated, or the reverse. As the Real Estate Advisory Committee stated, "the most overriding need . . . is the need for uniformity;" "investor protection is not likely to be served by layered and inconsistent guidelines." REAL ESTATE REPORT, *supra* note 51, at 24, 32.

³²⁴ Section 24(d) provides that Securities Act §§ 3(a)(8) (insurance contracts) and 3(a)(11) (intrastate offerings), 15 U.S.C. §§ 77c(a)(8), (11) (1970), do not apply to any security issued by an investment company. Securities Act rule 240, which exempts certain limited offers and sales by closely held issuers, is also not available to any registered investment company. 17 C.F.R. § 230.240(b) (1975). Thus, the nonpublic offering exemption of Securities Act § 4(2), 15 U.S.C. § 77d(2) (1970), as interpreted by rule 146, 17 C.F.R. § 230.146 (1975), is the only exception to full registration available to investment companies registered under Investment Company Act § 3(c)(1). This narrowing of the exemptions from registration is extremely important in view of estimates that 90% of all real estate and other tax shelter offerings are intrastate or nonpublic offerings. REAL ESTATE REPORT, *supra* note 51, at 11-12. See also NASD, [1973-1974 Transfer Binder] CCH FED. SEC. L. REP. ¶ 79,810, at 84,194 (SEC staff letter, May 6, 1974) (concerning NASD's proposed tax shelter rules):

The greater part of the offerings of tax shelter programs, by dollar volume, appears to be sold in transactions characterized by the participants as not involving a public offering, and the Commission urges the [NASD] to emphasize that a member's obligation with respect to suitability exists in connection with every recommendation for the purchase of a security, not merely those made in connection with offerings that are classified as public by the [NASD].

forcement actions (whether Commission-initiated or private); that would be a piecemeal regulatory approach, highly dependent upon good timing and good luck. What is needed is a regulatory statute³²⁵ along the lines of the Investment Company Act addressed directly to the abuses, including overreaching,³²⁶ conflicts of interest,³²⁷ and excessive compensation.³²⁸ To the extent that the Advisory Committee's rejection of an Investment Company Act-type regulatory scheme for real estate tax shelters was premised on its belief that section 17 would have imposed an unreasonable burden on the industry, revision of that section along the lines we have proposed will, we believe, meet those objections.

Accordingly, we recommend that Professors Loss and Brudney and the ALI consider regulatory provisions for real estate syndications and all other tax shelter investment vehicles formed as limited partnerships.³²⁹ REITs, on the other hand, would not fit comfortably into provisions for limited partnerships, but could fit comfortably within the ALI Code provisions patterned after the Investment Company Act.

V. CONCLUSION

We have made a number of suggestions regarding amendment of the Investment Company and Investment Advisers Acts which, in our view, would cure errors, omissions, and needless

³²⁵ We recognize that there will always be frauds, detailed disclosure documents and regulatory statutes notwithstanding: That has certainly been the Commission's experience with all of the federal securities laws. However, the existence of a strong regulatory statute engenders fairness at the outset and, by its mere existence, tends to prevent or inhibit certain types of frauds. Moreover, a good inspection program and aggressive self-regulation under such a statute can also provide substantial investor protection against overreaching, conflicts of interest, and excessive compensation. In other words, although there may still be a need to improve disclosure and to improve detection of and enforcement against frauds, a regulatory statute governing real estate and other tax shelters is needed to provide investor protection in those situations where full disclosure is not enough and actions for fraud are just too late.

³²⁶ See text accompanying notes 157-76 *supra*.

³²⁷ See text accompanying notes 177-204 *supra*.

³²⁸ See text accompanying notes 137-57 *supra*.

³²⁹ It was recently reported that the Real Estate Securities and Syndication Institute was drafting a model real estate securities law for submission in all state legislatures. *Uniform State Real Estate Securities Laws Sought*, BNA SEC. REG. & L. REP. No. 301, at A-22 to A-23 (May 7, 1975).

One striking example of the inadequacy of state law to furnish significant investor protection is that, under the law of limited partnerships applicable in most jurisdictions, any attempt on the part of the limited partner to oversee the partnership's business may

complexities in the two 1940 Acts, and which would seem to fall clearly within the scope and spirit of the ALI Federal Securities Code Project. Our last three recommendations, regarding ICC companies, oil and gas programs, and tax shelters and REITs may be more controversial,³³⁰ in that we would impose a federal regulatory statute where one does not now exist. We believe, however, that an improved regulatory environment for those industries would be in the public interest and appropriate for the protection of investors, and therefore should be given serious consideration by Professors Loss and Brudney and the ALI.

be deemed an exercise of "control" with the result that the privilege of limited liability is forfeited. See REAL ESTATE REPORT, *supra* note 51, at 95-97.

³³⁰ Although we believe that our recommendations regarding ICC companies, oil and gas programs, and tax shelters and REITs would provide significant investor protections, are long overdue, and warrant serious consideration, we are not unmindful of the political considerations which Professors Loss and Brudney and the ALI must take into account. Moreover, we believe the ALI Code project is an extremely important endeavor and wish to make clear our support of its central purpose. Thus, we would understand a decision by the ALI not to propose regulatory provisions in the oil and gas, tax shelter, and REIT areas if such a proposal would, in their view, ultimately jeopardize passage of the overall ALI Code.

AN ANALYSIS OF THE PROPOSAL TO "ABOLISH" THE INSANITY DEFENSE IN S. 1: SQUEEZING A LEMON

HEATHCOTE W. WALES†

I. INTRODUCTION

As debate over the function and administration of the insanity defense has heightened in recent years, abolition of the defense has become an increasingly serious alternative.¹ The Senate Committee on the Judiciary is now considering one such proposal. Section 522 of the proposed Criminal Justice Reform Act of 1975,² popularly known as S. 1, states a viable defense if "the defendant, as a result of mental disease or defect, lacked the state of mind required as an element of the offense charged. Mental disease or defect does not otherwise constitute a defense."

Born of frustrations over the administration of the insanity

† Associate Professor of Law, Georgetown University, A.B. 1965, University of North Carolina; J.D. 1968, University of Chicago.

¹ For the abolitionist positions, see, e.g., S. HALLECK, *PSYCHIATRY AND THE DILEMMAS OF CRIME* 212-28, 341-42 (1967); H.L.A. HART, *THE MORALITY OF THE CRIMINAL LAW* 24-25 (1964); T. SZASZ, *LAW, LIBERTY, AND PSYCHIATRY* 123-46 (1963); B. WOOTTON, *CRIME AND THE CRIMINAL LAW* (1963); Goldstein, *The Brawner Rule—Why? or No More Nonsense on Non Sense in the Criminal Law, Please!*, 1973 WASH. U.L.Q. 126; Goldstein & Katz, *Abolish the "Insanity Defense"—Why Not?*, 72 YALE L.J. 853 (1963); Morris, *Psychiatry and the Dangerous Criminal*, 41 SO. CAL. L. REV. 514 (1968). Dean Morris' article contains a summarization of the various positions in an appendix. *Id.* 544-47.

For arguments that the insanity defense be retained, see, e.g., H. FINGARETTE, *THE MEANING OF CRIMINAL INSANITY* 1-15 (1972); A. GOLDSTEIN, *THE INSANITY DEFENSE* 222-26 (1967); H. PACKER, *THE LIMITS OF THE CRIMINAL SANCTION* 131-35 (1968); Brady, *Abolish the Insanity Defense?—No!*, 8 HOUSTON L. REV. 629 (1971); Kadish, *The Decline of Innocence*, 26 CUMB. L.J. 273 (1968); Monahan, *Abolish the Insanity Defense?—Not Yet*, 26 RUTGERS L. REV. 719 (1973).

Platt, *The Proposal to Abolish the Federal Insanity Defense: A Critique*, 10 CAL. WESTERN L. REV. 449 (1974), discusses constitutional objections to the Nixon Administration's abolition proposals, but does not consider the manner in which judicial construction can undercut abolition through an expanded version of *mens rea*. See text accompanying notes 100-31 *infra*.

² S. 1, 94th Cong., 1st Sess. (1975). All citations to S. 1 in this Article refer to the Committee Print of May 16, 1975.

defense, the death of the *Durham* experiment,³ and the rising influence of the behaviorist position,⁴ the abolitionist argument has become respectable for liberal and conservative alike. A forerunner to section 522 was proposed by a consultant to the National Commission on Reform of Federal Criminal Laws (Brown Commission) in 1970 but was rejected by the Commission.⁵ Abolition of the insanity defense reemerged in the Nixon Administration bill in 1973⁶ and has remained in the Judiciary Committee's bill ever since.

Section 522 is abolitionist in the sense of eliminating a "separate insanity defense."⁷ Although evidence of mental disease or defect is admissible if it tends to negate the mental ele-

³ See *United States v. Brawner*, 471 F.2d 969 (D.C. Cir. 1972) (en banc), *overruling* *Durham v. United States*, 214 F.2d 862 (D.C. Cir. 1954).

The *Durham* experiment was itself born of frustrations over what Judge Bazelon and his colleagues on the District of Columbia Circuit considered the limited scope of expert psychiatric testimony under the *M'Naghten* rule, *M'Naghten's Case*, 8 Eng. Rep. 718 (H.L. 1843). See *Durham*, *supra* at 866-74. Largely indigenous to the District of Columbia Circuit (New Hampshire has followed a similar rule for nearly a century, see, e.g., *State v. Pike*, 49 N.H. 399 (1870)), *Durham* exculpated from criminal punishment those individuals whose forbidden acts were "the product of a mental disease or defect." *Durham*, *supra* at 874-75. The standard underwent great flux before its demise. See *Carter v. United States*, 252 F.2d 608 (D.C. Cir. 1957) (requiring "but for" causation); *Blocker v. United States*, 274 F.2d 572 (D.C. Cir. 1959) (per curiam) (requiring updated expert testimony on whether a sociopathic personality disturbance is to be considered a mental disease or defect); *McDonald v. United States*, 312 F.2d 847 (D.C. Cir. 1962) (en banc) (defining mental disease or defect); *Washington v. United States*, 390 F.2d 444 (D.C. Cir. 1967) (criticizing conclusory psychiatric labels). Finally, in *Brawner*, the District of Columbia Circuit—with Judge Bazelon concurring in part and dissenting in part, *Brawner*, *supra* at 1010-39—rejected the *Durham* rule, citing as its chief defect the domination of the trier of fact by expert medical and psychiatric witnesses on the issue of insanity, *id.* at 977-78. The court adopted a modified version of the American Law Institute rule. Compare *id.* at 990-94, 1006 n.82, 1008, with MODEL PENAL CODE § 401 (Proposed Official Draft 1962).

Though now abandoned and largely unsuccessful in accomplishing its stated goals, *Durham* at least proved fruitful in stimulating scholarly and judicial debate on the nature and purposes of the insanity defense. See *Brawner*, *supra* at 976.

⁴ See, e.g., B. WOOTTON, *supra* note 1; Monahan, *supra* note 1, at 733-38.

The behaviorist position stresses that free will is an illusion and that behavior is conditioned by numerous forces, so that the sole function of the criminal law should be to modify the personalities of those committing antisocial acts. Accordingly, insanity becomes relevant only at the sentencing-dispositional stage. See H. PACKER, *supra* note 1, at 12.

⁵ See 1 WORKING PAPERS OF THE NATIONAL COMM'N ON REFORM OF FEDERAL CRIMINAL LAWS 234 (1970) [hereinafter cited as WORKING PAPERS].

⁶ S. 1400, 93d Cong., 1st Sess. § 502 (1973): "It is a defense to a prosecution under any federal criminal statute that the defendant, as a result of mental disease or defect, lacked the state of mind required as an element of the offense charged. Mental disease or defect does not otherwise constitute a defense."

⁷ See STAFF OF SENATE COMM. ON THE JUDICIARY, 93d Cong., 2d Sess., REPORT ON CRIMINAL JUSTICE CODIFICATION, REVISION, AND REFORM ACT OF 1974, at 111 n.73 (Comm. Print 1974) [hereinafter cited as JUDICIARY COMM. STAFF REPORT].

ment (*mens rea*) of a crime, it does not constitute a general defense of excuse. Proponents are fond of the illustration of the man who strangles his wife believing he is merely squeezing lemons.⁸ His defense is that he lacked the intent to kill another human being. His need for introducing evidence of mental disease would be to give credibility to his story.⁹ If section 522 is indeed restricted to such delusional mistakes of fact, then the draftsmen have succeeded in largely abolishing the insanity defense as we now know it.

Two problems are posed. First, one may question whether such alteration of the insanity defense can coexist with an otherwise rather traditional structure of criminal liability and defenses without standing the logic of that structure on its head. This question poses corollary issues of policy and constitutional interpretation.¹⁰ Second, one may question whether judicial construction of this "decidedly opaque"¹¹ provision will conform to the expectations of the draftsmen. Distinguished students of the insanity defense have inferred a remarkably broad range of interpretations of the meaning and effect of section 522.¹²

⁸ *Id.* 106. The illustration is drawn from MODEL PENAL CODE § 4.01, Comment 2 (Tent. Draft No. 4, 1955).

⁹ Given the redundancy between §§ 522 and 521 (mistake of fact or law), *see* notes 101-10 *infra* & accompanying text, it is unclear whether the trier of fact must find that the defendant had a mental disease or defect as a precondition to allowing a defense in the lemon-squeezing illustration. Section 522 implies that such a finding of fact is necessary, as does § 3617(c)(4)(B), which requires the expert witness' conclusion on that issue. Yet the defendant's proof would be simplified if he could bring his defense under § 521; and, if successful, he could win outright acquittal rather than the special verdict of acquittal by reason of insanity with its accompanying civil commitment procedures under §§ 3612-13. *See* note 31 *infra*.

¹⁰ *See* text accompanying notes 13-99 *infra*. The due process clause may well be offended by either partial or total abolition, text accompanying notes 84-99 *infra*.

¹¹ *Hearings on S. 1 Before the Subcomm. on Criminal Laws and Procedures of the Senate Comm. on the Judiciary*, 94th Cong., 1st Sess., pt. XII, at 219 (1975) (statement of Chief Judge David L. Bazelon, Jr.) [hereinafter cited as *1975 Hearings*].

¹² While there is a very vague intent to restrict the insanity defense, the use of the terms "mental disease or defect" ambiguously indicates some form of *Durham*-like experimentation. . . . [T]he Section could be read as endorsing either the view of the court in *Brawner* on the role of the jury or the view expressed in my dissenting opinion.

Id. 288 (statement of Chief Judge David L. Bazelon, Jr.).

"The . . . approach is strikingly reminiscent of the *Durham* rule." *Hearings on S. 1 & S. 1400 Before the Subcomm. on Criminal Laws and Procedures of the Senate Comm. on the Judiciary*, 93d Cong., 1st Sess., pt. VIII, at 6381 (1973) (statement of Prof. Abraham S. Goldstein) [hereinafter cited as *1973 Hearings*].

"In effect, S. 1 abolishes the defense of insanity, since lack of the required criminal intent is a defense, independent of insanity, in any case." Schwartz, *A Proposal to Overhaul the Federal Criminal Laws*, N.Y. Times, June 22, 1975, § 4 (Week in Review), at 4, col. 5.

II. THE LEMON SQUEEZING VIEW

If we take the draftsmen at their word, section 522 would exculpate mistakes of fact arising from grossly abnormal ideation and little else.¹³ The lemon-squeezing spouse-killer would be acquitted if the jury were persuaded that he literally thought that his wife was a lemon.¹⁴ But if the same defendant was spurred to kill by voices, by a prolonged depression, or by an uncontrollable rage associated with a tumor or other organic damage, he should be convicted.¹⁵ Not only would the defense discriminate against particular types of disorders—particularly the affective disorders such as manic-depressive psychosis—but it would also discriminate among phases of delusions arising from a single thought disorder. Thus our lemon-fixated defendant who dispatches his wife while trying to grip her firmly to prevent her turning into a lemon is guilty of reckless homicide.¹⁶

Beneath this interpretation of section 522 lies the criminal law's traditional objective view of *mens rea*. The defendant is assumed to be a rational being exercising free choice.¹⁷ Gradations of culpability are geared to the actor's awareness of his conduct, the circumstances in which he acts, and the consequences of his conduct, as well as to an evaluation of the objective conduct, circumstances, and consequences themselves.¹⁸

¹³ See JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 106. Similarly, if *A* suffers from paranoid delusions that *B* is trying to kill him, and *A* kills *B*, *A* would be entitled to an imperfect defense of self-defense, reducing his crime to reckless or negligent homicide. See S. 1, 94th Cong., 1st Sess. § 544(b) (1975).

¹⁴ Actually he could be convicted of negligent homicide, S. 1, 94th Cong., 1st Sess. § 1603 (1975), unless the subjective aspect of negligence—"a reasonable person . . . in such a situation," *id.* § 302—were enlarged to include his mental abnormality. See Kadish, *supra* note 1, at 280.

¹⁵ See JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 107 n.64.

¹⁶ A similar case occurred recently in Washington, D. C. Defendant, waiting at a bus stop, perceived that a woman stranger standing near him was rapidly changing shapes. He proceeded to throttle her—as he explained it, to make her stay in one form so that he could talk to her. The woman was near death when the man was pulled away by onlookers. The police, rather than booking him, delivered him to St. Elizabeth's Hospital for reasons of convenience to the police, and the man was civilly committed. No criminal charges were filed. Conversation between Herbert M. Silverberg, Chief, Mental Health Division, Public Defender Service, St. Elizabeth's Hospital, Washington, D.C., and the author, Dec. 3, 1974.

¹⁷ "Historically, our substantive criminal law is based upon a theory of punishing the vicious will. It postulates a free agent confronted with a choice between doing right and doing wrong and choosing freely to do wrong." *Morissette v. United States*, 342 U.S. 246, 250 n.4 (1952), (*quoting* Pound, *Introduction* to F. SAYRE, *CASES ON CRIMINAL LAW* xxxvi-xxxvii (1927)). See also *Durham v. United States*, 214 F.2d 862, 876 (D.C. Cir. 1954). 4 W. BLACKSTONE, *COMMENTARIES* *20-21.

¹⁸ "If a man intentionally adopts certain conduct in certain circumstances known to

Therefore, the only way to negate *mens rea*, strictly speaking, is to demonstrate the absence of awareness of the conduct, circumstances, or consequences to which the *mens rea* applies. In so doing, one never reaches the underlying assumption that the defendant is a rational being.

Mens rea has not always been so narrow a construct.¹⁹ Terms such as "malice," "premeditation," and "deliberation" have from time to time incorporated into the criminal law qualitative concepts of culpability beyond mere awareness of conduct, circumstances, and consequences. Recent codification efforts, however, including sections 301 and 302 of S. 1, have followed the lead of the Model Penal Code in refining a more objective concept of *mens rea*.²⁰ Thus, the lemon-squeezing view of section 522 is consistent with the emerging view of *mens rea*.

But what of the underlying assumption of free will? The Model Penal Code and virtually every code derived from it provide at least two defenses unrelated to *mens rea* that may negate the threshold capacity for free choice assumed by the criminal law. One, the automatism or involuntariness defense, negates a prescribed element of the crime, the requirement of a *voluntary* act or omission.²¹ The other, the insanity defense, assumes a voluntary or conscious act and is directed at *substantial impairments to the capacity for free choice* arising from *mental disorder*.²² Together, the two defenses suggest a concept of culpability broader than that reflected by the element of *mens rea*.²³ It is only when the two-step hurdle of minimal capacity for free choice has been crossed—whether by presumption or by the state's overcoming defense evidence—that the more refined measures of culpability contained in the *mens rea* element are brought into play. Yet neither defense exists on the face of S. 1.²⁴

him, and that conduct is forbidden by law under those circumstances, he intentionally breaks the law in the only sense in which the law ever considers intent." *Ellis v. United States*, 206 U.S. 246, 257 (1907).

¹⁹ See generally Turner, *The Mental Element in Crimes at Common Law*, 6 CAMB. L.J. 31 (1936).

²⁰ MODEL PENAL CODE § 2.02 (Proposed Official Draft 1962).

²¹ See, e.g., MODEL PENAL CODE § 2.01 (1) (Proposed Official Draft 1962). See generally W. LAFAVE & A. SCOTT, CRIMINAL LAW 179-81 (1972).

²² See, e.g., MODEL PENAL CODE § 4.01 (Proposed Official Draft 1962).

²³ Other defenses, such as duress, self-defense, and provocation, also tend to reflect a broader, more subjective notion of culpability. See generally notes 111-13 *infra* & accompanying text.

²⁴ See S. 1, 94th Cong., 1st Sess. §§ 102, 111 (1975). But see *id.* § 501 (defenses listed in S. 1 are not exclusive).

A. *The Committee's Rationale*

The Senate Judiciary Committee's Staff Report²⁵ does not directly confront the significant changes in the culpability concept implied in the lemon-squeezing interpretation of section 522. Rather, the Report criticizes current formulations of the insanity defense as vague, wasteful, and inefficient and urges simple abolition of the inquiry into concepts of responsibility in favor of more efficient procedures for sorting out and designating for treatment those offenders exhibiting psychopathology of any variety.²⁶ "The critical issue is seen as one of disposition."²⁷

Indeed, the Report advances the novel argument²⁸ that dispositional proceedings constitute a proper forum for determining culpability.

[T]he stigma attached to a determination of criminality will be materially mitigated at the sentencing stage by publicly adjudging [persons convicted under S. 1 who would have been acquitted under other insanity tests] to be deserving of proper medical care rather than deserving of a punitive sentence of imprisonment. The nature of the disposition . . . will constitute society's recognition of the defendant's lack of moral culpability for his offense.²⁹

Dean Morris has argued that the current practice of delivering a special verdict of acquittal by reason of insanity combined with the commitment of insanity acquittees amounts to double stigmatization of the defendant as both bad and mad.³⁰ Surely a criminal conviction combined with commitment to a psychiatric facility for criminals will not ameliorate the stigma visited upon this unfortunate class.³¹ Furthermore, hospitalization of a con-

²⁵ JUDICIARY COMM. STAFF REPORT, *supra* note 7.

²⁶ These procedures can be found in S. 1, 94th Cong., 1st Sess. §§ 3611-17 (1975).

²⁷ JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 106.

²⁸ See B. WOOTTON, *supra* note 1. In contrast to the Woottonian position, which attempts to eliminate all elements of culpability, the S. 1 abolitionist approach would apparently retain culpability while allowing psychiatric evidence at the dispositional hearing of an offender convicted because he was unable to establish a mistake-of-fact defense based on mental disease or defect.

²⁹ JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 107.

³⁰ Morris, *supra* note 1, at 524-25.

³¹ See Kadish, *supra* note 1, at 283; Monahan, *supra* note 1, at 729-31. For those few who may be acquitted under § 522, the same, less formal double stigmatization occurs. Defendants are accorded a "special verdict" of "not guilty by reason of insanity" under § 3612 and are subjected to proceedings under § 3613 to determine whether they should be indefinitely hospitalized as mentally ill and dangerous.

victed person under S. 1 occurs when the person is found to be suffering from a mental disease or defect and in need of treatment,³² so that persons who might have been acquitted under other insanity tests will be grouped with all other prisoners who might benefit from psychiatric care, whether or not their mental disabilities contributed to their criminal conduct. Finally, disposition occurs without a jury³³ and in substantial reliance on a psychiatrist's opinion as to the prisoner's present mental condition. Culpability is simply not in issue.

On a practical level, substituting criminal sentences with medical treatment for the indefinite commitments usually given to persons acquitted under current insanity tests is no favor to the accused, despite the Committee's suggestion to the contrary.³⁴ Maximum sentences under S. 1 are already substantial, and section 3616 permits indefinite commitment of prisoners whose sentences have expired but who are found to be mentally ill and dangerous. A convicted person is compelled to receive psychiatric treatment under sections 3614 and 3615 until he is no longer in need of treatment, whereas section 3613 requires treatment of the insanity acquittee only so long as he is mentally ill and dangerous. When the prisoner is discharged from treatment, he may have to return to prison for the remainder of his sentence,³⁵ a factor that may discourage discharge.³⁶ In short, convicting those who might otherwise win insanity acquittals subjects such

³² S. 1, 94th Cong., 1st Sess. §§ 3614(d), 3615(d) (1975). Because of its extreme breadth and flexibility, the standard "in need of treatment" raises serious policy and constitutional questions. Some psychiatrists would view almost any prisoner to be in need of treatment. See, e.g., Menninger, *Medicolegal Proposals of the American Psychiatric Association*, 19 J. CRIM. L.C. & P.S. 367, 373 (1928). For the argument that "commitment on these grounds [mentally ill or in need of treatment] is of necessity a completely arbitrary act," see Ennis & Litwack, *Psychiatry and the Presumption of Expertise: Flipping Coins in the Courtroom*, 62 CALIF. L. REV. 693, 748 (1974). See also *Developments in the Law—Civil Commitment of the Mentally Ill*, 87 HARV. L. REV. 1190, 1212-19 (1974).

³³ S. 1, 94th Cong., 1st Sess. §§ 3614(d), 3615(d) (1975); see 1973 *Hearings, supra* note 11, at 6379; Gray, *The Insanity Defense: Historical Development and Contemporary Relevance*, 10 AM. CRIM. L. REV. 559, 583 n.103 (1972).

³⁴ JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 108-09.

³⁵ Persons committed while they are serving prison sentences, S. 1, 94th Cong., 2d Sess. § 3615 (1975), must be returned to prison for the remainder of their sentences upon discharge from the hospital, *id.* § 3615 (e). However, persons committed after conviction but prior to sentencing, *id.* § 3614, may, upon discharge from the hospital, obtain adjustment of sentence, *id.* § 3614(e). The tradeoff is that § 3614 commitments are given provisional maximum sentences for their offenses at the time of commitment, *id.* § 3614(d).

³⁶ Some psychiatrists may be reluctant to return patients to prison for fear that the prison environment will occasion a relapse. Should this occur in the context of § 3614 commitments, persons so committed would in effect be receiving automatic maximum

persons to incarceration for a period determined by their past criminal conduct as well as by their future propensities, whereas commitment of insanity acquittees, in theory at least, relates only to future dangerousness.³⁷

Nor can we take comfort in the Committee's second justification for criminalizing the class that under current insanity tests would be acquitted. In one breath, the Committee suggests that the injustice wrought by extending culpability to this class will be minimal because the class is so small.³⁸ In the next breath, the Committee urges the benefits to the criminal justice system of convicting members of this meager class who should and would have been convicted but for the vagaries of existing insanity formulations.³⁹ Playing the numbers both ways is awkward enough; suggesting that it is better to convict ten nonculpable persons than to let one malingerer go free is strange talk indeed.⁴⁰

The remaining justifications advanced by the Committee for narrowing the insanity defense form a catalog of the criticisms directed at existing insanity tests. With one exception, all of these criticisms are equally applicable to section 522. Like other formulations, the section 522 defense is subject to expert domination, both because it is tied to a factual finding of "mental disease or defect"⁴¹ and because psychiatric experts are required by section

sentences solely because they were found mentally ill and in need of hospitalization. See note 35 *supra*.

Furthermore, insanity acquittees committed under § 3613 are likely to be deemed by the courts to be entitled to the least restrictive form of confinement and/or treatment consistent with their mental condition and degree of dangerousness. See generally *Covington v. Harris*, 419 F.2d 617 (D.C. Cir. 1969); Chambers, *Alternatives to Civil Commitment of the Mentally Ill: Practical Guides and Constitutional Imperatives*, 70 MICH. L. REV. 1107 (1972). The application of the least restrictive alternative doctrine will of necessity be more restrictive for those committed while awaiting or serving criminal sentences under §§ 3614-15.

³⁷ To the extent that theory does not conform to practice, see note 49 *infra*, the better approach would seem to be to reform the practice rather than to adulterate the theory.

³⁸ JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 107 n.63.

³⁹ *Id. But cf. State v. Strasburg*, 60 Wash. 106, 131, 110 P. 1020, 1028 (1910) (Rudkin, C.J., concurring): "[T]he remedy for acquittals through maudlin sentiment or in response to popular clamor must be sought by correcting false notions, and not by destroying the safeguards of private liberty."

⁴⁰ Even if we can agree on who "should" have been acquitted by reason of insanity, it is unlikely that the number of persons "improperly" acquitted is very large. Most persons who might qualify for the defense never go to trial on the issue. See A. GOLDSTEIN, *supra* note 1, at 23-24; Morris, *supra* note 1, at 519.

⁴¹ See note 9 *supra*. See also *Washington v. United States*, 390 F.2d 444 (D.C. Cir. 1967); 1975 Hearings, *supra* note 11, at 225 (statement of Chief Judge David L. Bazelon, Jr.).

3617 (c)(4)(B) to give conclusory testimony on whether the mental disease or defect operated to negate the defendant's *mens rea* at the time of the offense.⁴² Like other formulations, section 522 is likely to remain a "rich man's defense"⁴³ because section 3617(b) denies the indigent accused the right to an independent psychiatrist. Like *M'Naghten*,⁴⁴ section 522 emphasizes cognitive mental functioning to the exclusion of all else. Like other formulations, section 522 mingles vague medical terms (mental disease or defect) unintelligible to lawyers with an unrelated moral-legal term (*mens rea*).⁴⁵ Like many existing procedural provisions, section 3613 insures that those few persons who are acquitted under section 522 will be hospitalized indefinitely if found to be mentally ill and dangerous.⁴⁶

The one criticism of existing insanity tests that section 522 does attempt to resolve is that psychiatric resources have been misallocated to the guilt-determination process when they could be devoted to treatment. If the courts adopt the strict lemon-squeezing view of section 522, a contingency that is questioned below,⁴⁷ then the number of defendants raising the insanity defense will probably drop, thereby reducing the allocation of psychiatric resources to determinations of guilt.⁴⁸ The possibility that such gains may be offset by other demands on psychiatric resources by other provisions of S. 1 is not considered in the Committee Staff's Report.⁴⁹

⁴² If the courts respond to § 522's limitation on the insanity defense, as I believe they will, by articulating a broader *mens rea* defense, see text accompanying notes 100-31 *infra*, expert conclusions will continue to dominate the adjudication stage.

⁴³ JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 108 n.65.

⁴⁴ *M'Naghten's Case*, 8 Eng. Rep. 718 (H.L. 1843).

⁴⁵ The Report confesses this defect but notes that "the reduction in availability of the defense reduces the harm and impact of the necessary vagueness." JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 110. That statement may be applicable to other defects in § 552 as well.

⁴⁶ Even in jurisdictions that do not make commitment of insanity acquittees automatic, in practice commitment ensues in virtually every case. See Pugh, *The Insanity Defense in Operation: A Practicing Psychiatrist Views Durham and Brawner*, 1973 WASH. U.L.Q. 87, 92 n.8. See also Goldstein, *supra* note 1 at 132-33.

⁴⁷ See notes 100-31 *infra* and accompanying text.

⁴⁸ See JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 111.

⁴⁹ For example, hearings required by §§ 3614-15 for hospitalization of persons who under other insanity tests might have been acquitted will require some psychiatric participation in an adversary setting. Similarly, persons committed under these sections may be hospitalized for longer periods than if they had been civilly committed. Cf. Burt, *Of Mad Dogs and Scientists: The Perils of the "Criminal-Insane"*, 123 U. PA. L. REV. 258, 261 (1974): "The systematic empirical research available in current literature has uniformly found that those persons caught in the 'criminal-insane' statuses are as a rule confined

The policy of getting psychiatrists out of the courtroom has multiple objectives,⁵⁰ not all of them commendable. To the extent that the draftsmen wish to end "the unseemly battle of the experts,"⁵¹ their solution seems misdirected. The battle becomes unseemly only when the experts stray beyond their expertise into opinions on law and morality, whether such wanderings are the result of their own foibles or the law's specific requests.⁵² Legislators might more profitably direct their efforts toward limiting the experts to testimony on their clinical assessments of a defendant's mental functioning at the time of the alleged offense.⁵³ Presumably, public disagreement between two psychiatrists over such clinical judgments does not diminish their stature or that of their profession.

Thus the Senate draftsmen address deficiencies in the operation of current insanity defense formulations by reducing the availability (and visibility) of the defense rather than by attempting to cure the deficiencies.⁵⁴ The draftsmen seem to perceive the defense as having failed as a mechanism for diversion of the sick offender to non-punitive treatment, a point already conceded by others on both practical⁵⁵ and constitutional⁵⁶ grounds. Hence, the primary drafting efforts in S. 1 for mentally abnormal offenders have been directed toward tightening up disposition procedures to insure such offenders' detention until they are no longer dangerous.⁵⁷ What is missing is an effort to recon-

for longer terms than comparable persons who are socially labeled either 'criminal' or 'insane' alone." See also text accompanying note 37 *supra*.

⁵⁰ See JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 111.

⁵¹ *Id.*

⁵² See Wales, *The Rise, the Fall, and the Resurrection of the Medical Model*, 63 GEO. L.J. 87, 91-93 (1974). Compare *Psychiatric News*, Feb. 5, 1974, at 23, col. 1 (Dr. Alan Stone, urging psychiatrists to stay out of the courtroom) with Bazelon, *Psychiatrists and the Adversary Process*, SCIENTIFIC AM., June 1974, at 18.

⁵³ Section 3617(c)(4)(B) takes directly the opposite approach, requiring psychiatrists to report in conclusory terms whether the defendant's mental disease or defect negated the mental elements in the crimes charged.

⁵⁴ See note 45 *supra*.

⁵⁵ See A. GOLDSTEIN, *supra* note 1, at 219.

⁵⁶ See *Bolton v. Harris*, 395 F.2d 642 (D.C. Cir. 1968) (Bazelon, J.) (interpreting D.C. CODE ANN. § 24-301(a), (d) (1967) to require pre-commitment hearing for insanity acquittees with procedures substantially similar to those in civil commitment proceedings, avoiding equal protection issue). See generally Note, *Commitment of Persons Acquitted by Reason of Insanity: The Example of the District of Columbia*, 74 COLUM. L. REV. 733 (1974); Comment, *Commitment Following Acquittal by Reason of Insanity and the Equal Protection of the Laws*, 116 U. PA. L. REV. 924 (1968).

⁵⁷ See S. 1, 94th Cong., 1st Sess. §§ 3611-17 (1975); JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 1000-18.

cile the changes wrought by section 522 with the criminal law's concept of culpability and fully to rationalize the preventive confinement scheme created by the new dispositional provisions.

B. *Abolition—A Second Look*

Dean Morris, whose stylish article may well have been the basis for the lemon-squeezing version of section 522,⁵⁸ addresses the culpability issue somewhat more fully than the Senate draftsmen, although he too is primarily concerned with removing psychiatrists from the courtroom to the correctional process. In so doing, he passes over the impact of his proposal on the emerging jurisprudence of preventive confinement.

Dean Morris begins by suggesting that current formulations of the insanity defense are too narrow. By conditioning the defense on a finding of mental disease or defect, the law ignores other equally potent impairments to the exercise of free will, such as "dwelling in a Negro ghetto."⁵⁹ If we are unwilling to recognize a broader defense of incapacity, a solution which, he argues, "would politically be intolerable,"⁶⁰ then we do no great injustice to eliminate the excuse based on mental illness.⁶¹

But what is meant by "politically . . . intolerable?" Dean Morris seems to suggest that because dwelling in a black ghetto is more criminogenic than being mentally ill, the former is a more

⁵⁸ Morris, *supra* note 1. It is unlikely, however, that Dean Morris would support the dispositional provisions of §§ 3611-17. *Id.* 529-36.

⁵⁹ *Id.* 520.

⁶⁰ *Id.*

⁶¹ This argument is bolstered by (1) the trend toward elimination of capital punishment, (2) the low incidence of the insanity defense, and (3) the problem of informal double stigmatization. *Id.* 518-19, 524-25. See note 31 *supra*.

The premise of point (2) above, incidentally, is highly doubtful. While it is true that the insanity defense itself is none too often invoked, it may well be that many accused who might otherwise have availed themselves of the defense are instead diverted to treatment facilities before reaching a full trial. One such diversion method is the competency hearing; formerly, if at such a hearing the accused was found incompetent to stand trial, under most statutes he was confined for such indeterminate period as it might take him to gain competency. See Burt & Morris, *A Proposal for the Abolition of the Incompetency Plea*, 40 U. CHI. L. REV. 66, 66-67 n.4 (1972). But see *Jackson v. Indiana*, 406 U.S. 715 (1972) (Blackmun, J.) (incompetency commitment cannot exceed "reasonable" period of time necessary to determine whether there is a substantial chance of defendant's attaining capacity to stand trial in the foreseeable future. Thus prosecutors may be pressed to negotiate pleas through, say, a finding of incompetency to stand trial, see A. BROOKS, LAW, PSYCHIATRY AND THE MENTAL HEALTH SYSTEM 332 (1974), but such pressure might well be reduced if the breadth of the insanity defense were narrowed by S. 1.

For a discussion of the abuse of competency hearings, see Ennis, *C.L.U. Client "Crazy but Competent,"* reprinted in A. BROOKS, *supra* at 334-37.

compelling defense than the latter.⁶² But being mentally healthy may also be more criminogenic than being mentally ill.⁶³ The issue is not what condition is most criminogenic but what condition so deprives an individual of the capacity for free choice that he cannot be held responsible for his conduct. And just as juries now convict in all but the most extreme cases of mental abnormality, one might expect a similar pattern should "dwelling in a Negro ghetto" become admissible evidence on the issue of criminal responsibility.⁶⁴ Nor would such a pattern suggest moral inconsistency in the law.⁶⁵ Our only inconsistency is in failing to allow the jury to hear all evidence relevant to a defendant's capacity for free choice. For it is the jury, not legal scholars, who are best situated and best equipped, assuming access to relevant evidence, to determine moral guilt.⁶⁶

But having dismissed one aspect of criminal responsibility⁶⁷ for its underinclusiveness, Dean Morris then argues for the retention of the aspect of moral responsibility borne by the objective version of *mens rea*. Accidental (non-negligent) criminal conduct and the delusional mistake of fact will continue to excuse whereas the offender who accurately perceives what he is doing but is powerless to exercise moral judgment will suffer conviction, imprisonment, and involuntary medical treatment.⁶⁸ In

⁶² Morris, *supra* note 1, at 520.

⁶³ See Diamond, *The Psychiatric Prediction of Dangerousness*, 123 U.P.A. L. REV. 439 (1974).

⁶⁴ One is tempted to speculate how a defense lawyer who intended to raise such a defense might proceed in selecting a jury. My own guess is that upper middle class, educated whites would be preferred over ghetto blacks.

⁶⁵ See Kadish, *supra* note 1, at 284 ("It is never a reason for adding to injustice that we are already guilty of some."); H. PACKER, *supra* note 1, at 133 ("The point is that our attitudes toward volitional impairment can change, and the criminal law can change with them"); 1973 *Hearings*, *supra* note 12, at 6377: "So long as we do not know what really 'causes' crime, the insanity defense will have to be framed in a way which permits juries to express the feelings of the community on the subject of responsibility."

⁶⁶ "[The insanity defense represents] a normative standard applied to conflicting clusters of fact and opinion by a jury, an institution which is the traditional embodiment of community morality and, therefore, well suited to determining whether a particular defendant, and his act, warrant condemnation rather than compassion." *Id.* 6377. See also note 136 *infra* & accompanying text.

⁶⁷ Dean Morris eschews consideration of the defense of automatism or involuntariness in his analysis. See Morris, *supra* note 1, at 528 n.33. Presumably his argument would extend to abolishing that defense as well.

⁶⁸ Under S. 1, 94th Cong., 1st Sess. § 3614 (1975), a convicted person suffering from a mental disease or defect may be involuntarily hospitalized upon motion of the Government after a hearing and an appropriate judicial determination. The insanity acquittee, on the other hand, may be hospitalized only if "his release would create a substantial danger to himself or to the person or property of another." *Id.* § 3613(a).

short, Dean Morris has rejected Lady Wootton's logical extension of his argument to postpone all considerations of culpability to the disposition proceeding.⁶⁹ But why? For purposes of imposing blame, the conduct of the Hadfields⁷⁰ and M'Naghtens would seem no more opprobrious than that of the lemon-squeezing spouse-killer. For purposes of deterrence, we may achieve greater success in punishing accidental behavior not rising to criminal negligence than we do in punishing violent street crime.⁷¹ Behavior-modifying treatment is clearly worth considering for the lemon-squeezing spouse-killer and may benefit the accident-prone as well; both types of offenders may pose the danger of future harm. Dean Morris' distinction poses many of the same difficulties as the current insanity defense.

From a larger perspective, Dean Morris sees his proposal for elimination of the insanity defense as a first step on the low road toward elimination of the concept of retribution from criminal law.⁷²

There is a choice. We could follow the pattern of gradually extending the exculpatory and allegedly destigmatizing defense of insanity to cover larger and larger slices of criminal conduct, until it encompasses most criminal behavior. Many working in this field favor the engulfing process. I do not oppose their purpose, but I do think their political judgment is wrong.⁷³

But Dean Morris' first step is not the most logical, only the most politically acceptable. And it is not clear that those who would "expand" the insanity defense by eliminating the restriction of mental disease or defect are aiming for the same goal. There may yet be utility in perpetuating our constructs of free will and blame in the face of mounting psychological evidence that free

⁶⁹ B. WOOTTON, *supra* note 1.

⁷⁰ Hadfield's Case, 27 Howell St. Tr. 1282 (K.B. 1800). Hadfield, who had brain damage from a war wound, attempted to assassinate King George III to save the world.

⁷¹ See Zimring & Hawkins, Deterrence and Negligent Behavior: A Preliminary Note (unpublished manuscript on file with the author), reporting on a 1965 study of key-losing behavior in a midwestern automobile plant and finding such behavior deterrable. See also F. ZIMRING & G. HAWKINS, DETERRENCE: THE LEGAL THREAT IN CRIME CONTROL 128-41 (1973).

⁷² See Morris, *supra* note 1, at 526: "I do not believe that systems of justice can long survive in which name calling and vengeance figure so prominently. If this be so, then the issue we are debating becomes one of how we can destigmatize our criminal law processes as rapidly as possible."

⁷³ *Id.*

will is illusory. Empirical evidence abounds for "the proposition that an individual's perception of personal responsibility or free will affects his behavior in important ways."⁷⁴ Until it can be shown that the insanity defense and related responsibility defenses do not "[reinforce] the average citizen's belief in his own personal responsibility,"⁷⁵ we may be better off maintaining the criminal law's emphasis on culpability.⁷⁶

Dean Morris himself illustrates our reliance on the principle of blameworthiness, observing that sentencing and parole decisions which reflect judgments of the offender's potential dangerousness are frequently made "[w]ithin the ambit of power defined by other purposes (most of them retributive)."⁷⁷ Because our ability to predict future dangerousness and to "cure" antisocial propensities is so tenuous, he argues, we should not create state power over a criminal's life on those bases alone.⁷⁸ Yet he has done just that by making the insane offender criminally liable for his conduct: He would defuse retribution as a justification for confinement by abolishing a significant aspect of culpability. Nor would deterrence be greatly advanced by criminalizing the insane. Society's real purposes in confining such offenders, for the most part, would be prevention and treatment.

The key point is that retribution and accompanying notions of blameworthiness constitute a substantial restraint on state power over the individual.⁷⁹ If we are to extend state power over individuals to the substantially blameless in an attempt to eradicate their dangerous propensities, we should do so directly and openly under the rubric of a new jurisprudence of preventive confinement rather than indirectly by warping traditional concepts of criminal accountability. The direct approach would

⁷⁴ Monahan, *supra* note 1, at 721.

⁷⁵ *Id.* 723. Professor Monahan postulates two psychological processes, neither of which has empirical support and either of which could occur in response to the law's embracing the insanity defense: (1) the "process of contrast," by which persons "contrast their own 'normal' behavior with that of the defendant" and thereby gain an increased sense of their own responsibility, and (2) the process of "assimilation," by which persons might respond to acquittals by questioning their own capacity to control their conduct. *Id.* 724-25.

⁷⁶ See A. GOLDSTEIN, *supra* note 1, at 223-26; 1973 *Hearings*, *supra* note 12, at 6378-79 (statement of Prof. Abraham S. Goldstein). See generally Reich, *Reflections*, THE NEW YORKER, June 19, 1971, at 52.

⁷⁷ Morris, *supra* note 1, at 532-33.

⁷⁸ Morris, *Impediments to Penal Reform*, 33 U. CHI. L. REV. 627, 637-44 (1966).

⁷⁹ See generally Kadish, *supra* note 1, at 287-89.

focus our attention on the real values at issue when the state seeks power to confine and treat those whose propensities we fear.

Most important of the unresolved issues in our jurisprudence of preventive confinement is the problem of proportionality.⁸⁰ Dean Morris' proposal would make confinement proportional with a proven past offense. Yet the primary rationale for such a link lies in retribution and deterrence, policies that are not seriously advanced by convicting the insane. If our real reasons for confinement are primarily preventive, then our theory of proportionality should be fixed on those harms we hope to prevent and on the degree of certainty with which we may anticipate such harms.⁸¹ Dean Morris' proposal would mask this issue from view.⁸²

The dispositional provisions of S. 1 illustrate how Dean Morris' proposal can be misused. In addition to "punishing" the insane for their past conduct, S. 1 would preventively confine the offender until he "has recovered from his mental disease or defect to such an extent that his release would no longer create a substantial danger."⁸³ Even if a reviewing court applies notions of proportionality to the latter, more obviously preventive portion of an offender's confinement, it will be shielded from scrutiny of the initial sentence which, though administered largely for preventive reasons, will appear nominally as a term of "punishment" (involving primarily retribution and deterrence)

⁸⁰ See Dershowitz, *Preventive Confinement: A Suggested Framework for Constitutional Analysis*, 51 TEXAS L. REV. 1277, 1321-24 (1973). See also Dershowitz, *Indeterminate Confinement: Letting the Therapy Fit the Harm*, 123 U. PA. L. REV. 297, 328-38 (1974).

⁸¹ A third element might be our capacity to alter the predicted behavior.

⁸² Professor Dershowitz' historical research has shown us that formal and informal systems of preventive confinement go back to the time of the Normans and seem unlikely to wither away in the imminent future. Dershowitz, *The Origins of Preventive Confinement in Anglo-American Law—Part I: The English Experience*, 43 U. CIN. L. REV. 1 (1974); Dershowitz, *The Origins of Preventive Confinement in Anglo-American Law—Part II: The American Experience*, 43 U. CIN. L. REV. 781 (1974). His findings support the hypothesis that as formal criminal conviction becomes more difficult, persons thought to be dangerous but not convictable are shunted to less formal systems of preventive confinement, much as the air in a balloon is squeezed from one end to another. In his terms then, Dean Morris is simply squeezing the preventive confinement end of the balloon and pushing those currently viewed as lacking criminal responsibility back into the criminal justice system. The alternative urged here is that we confront the reality of preventive confinement and develop a jurisprudence to either tame or eliminate it. Whether pursuit of this alternative will cause other air pockets to form—e.g., the expansion of surveillance and intelligence systems—remains to be seen.

⁸³ S. 1, 94th Cong., 1st Sess. § 3616 (1975).

for past conduct. The state will have won two periods of preventive confinement for the price of one.

C. *Constitutional Considerations*

Oddly enough, Dean Morris' one-step-at-a-time approach to the destigmatization of the criminal law may be more difficult to square with the constitutional precepts of substantive due process and cruel and unusual punishment than Lady Wootton's more radical proposal of a totally behaviorist approach. For as long as courts view stigmatization as a significant component of criminal conviction, they will impute to the criminal conviction a quantum of blameworthiness greater than that reflected in the objective⁸⁴ version of *mens rea*.⁸⁵ Efforts to exclude defenses to the larger notion of culpability will thus be viewed with some suspicion, particularly when such defenses are as deeply imbedded in common law as are insanity and automatism.

That such defenses *are* so deeply imbedded in the common law may account for the infrequency of legislative attempts to eliminate the insanity defense and the consequent lack of case law on the constitutionality of such efforts. Only two states have seriously attempted to abolish this defense,⁸⁶ while a third attempted to transfer the power to rule on insanity to experts and thus beyond the court's jurisdiction.⁸⁷ Perhaps the best statement of the matter is found in the plurality opinion in *State v. Strasburg*,⁸⁸ wherein the Washington supreme court, on state constitutional grounds, invalidated a statute excluding evidence of insanity from criminal trials. The defendant's sanity at the time of the act charged, ruled three of the justices, is "as much a substantive fact, going to make up his guilt, as the fact of his

⁸⁴ The "objective" version of *mens rea* is that version that refuses to find culpability without an erroneous perception of fact.

⁸⁵ See generally note 17 *supra*.

⁸⁶ See *Sinclair v. United States*, 161 Miss. 142, 132 So. 581 (1931) (per curiam) (invalidating Act of Apr. 3, 1928, ch. 75, [1928] Miss. Gen. Laws 92, on state due process grounds, with three of six justices authoring or joining in concurring opinions, 161 Miss. at 154-71, 132 So. at 582-88, attacking statute on federal due process and eighth amendment grounds); *State v. Strasburg*, 60 Wash. 106, 110 P. 1020 (1910) (invalidating Act of Mar. 22, 1909, ch. 249, § 7, [1909] Wash. Sess. Laws 891, on state due process grounds, with at least three and possibly a majority of justices, 60 Wash. at 110-32, 110 P. at 1020-28, finding statute violative of right to jury trial under state constitution). See also *Commonwealth v. Vogel*, 440 Pa. 1, 268 A.2d 89 (1970).

⁸⁷ See *State v. Lange*, 168 La. 958, 123 So. 639 (1929) (invalidating Act of Dec. 18, 1928, [1928] La. Acts Extra Sess. 34).

⁸⁸ 60 Wash. 106, 110 P. 1020 (1910).

physical commission of the act.”⁸⁹ These justices explained:

If he was insane at the time to the extent that he could not comprehend the nature and quality of the act—in other words, if he had no will to control the physical act of his physical body, how can it in truth be said that the act was his act? To take from the accused the opportunity to offer evidence tending to prove this fact, is, in our opinion, as much a violation of his constitutional right of trial by jury as to take from him the right to offer evidence before the jury tending to show that he did not physically commit the act or physically set in motion a train of events resulting in the act.⁹⁰

At first glance, this reasoning suggests that evidence of insanity may be relevant to negate any or all of the three major components of criminal liability—*mens rea*, *actus reus*, and causation.⁹¹ By subsequently suggesting that the insanity defense must be permitted even in crimes of strict liability,⁹² the justices clearly indicated that the defense goes to a concept of culpability broader than *mens rea*. Thus they may have viewed insanity as going to the defendant's capacity for criminal responsibility—an issue not necessarily raised directly by the elements of *mens rea*, *actus reus*, and causation, but one that could not be taken from the jury's ultimate consideration of guilt or innocence.

Although *Strasburg* was based on the state constitution, its reasoning could be used in a federal constitutional challenge. The factual distinction between the total abolition statute in *Strasburg* and the near total abolitionary rule of S. 1's section 522 should give little comfort to the Senate draftsmen.⁹³ The Washington justices clearly viewed evidence of insanity to be relevant (and therefore constitutionally nonexcludable) to aspects of culpability beyond those reflected in the defense of mistake of fact. Moreover, S. 1's apparent exclusion of an involuntariness defense to the conduct element would render section 522 unconstitutional under the *Strasburg* reasoning.⁹⁴

⁸⁹ *Id.* at 119, 110 P. at 1024.

⁹⁰ *Id.* Although phrased in terms of the right to a jury trial, the justices' argument more closely resembles a substantive due process approach.

⁹¹ *Cf. Dix, Psychological Abnormality as a Factor in Grading Criminal Liability: Diminished Capacity, Diminished Responsibility, and the Like*, 62 J. CRIM. L.C. & P.S. 313, 327-28 (1971).

⁹² 60 Wash. at 120-21, 110 P. at 1024.

⁹³ See WORKING PAPERS, *supra* note 5, at 252.

⁹⁴ See note 24 *supra*. The Brown Commission's minority proposal was that evidence

More recently, five United States Supreme Court Justices have stated in dictum that punishment of involuntary conduct may violate the constitutional ban on cruel and unusual punishment. In *Powell v. Texas*⁹⁵ Mr. Justice White joined the four dissenters in suggesting that if a defendant acted under compulsion (in that case, compulsion from intoxication), his conviction would violate the eighth amendment.⁹⁶ Although the Court was unwilling, and quite properly so, to freeze experimentation with insanity defense formulations by articulating a constitutional formula for involuntariness,⁹⁷ a majority was willing to require at least some defense based on the impairment of free will.

It would be folly to state categorically that, assuming adoption of the lemon-squeezing interpretation, section 522 will be ruled unconstitutional.⁹⁸ But one *can* predict that many courts will be less than overwhelmed by the Senate Judiciary Committee's scanty justification for so major a departure from common law tradition on the culpability issue. Given judicial reluctance to constitutionalize the insanity defense,⁹⁹ the more probable fate of section 522 in the courts is that it will be construed in such a manner as to resolve indirectly the serious and difficult constitutional questions it provokes. It is to this subject that we now turn.

III. ENLARGING *MENS REA*

Motivated by constitutional concerns and the policy interests in not "depriv[ing] the criminal law of its chief paradigm of free

of mental disease or defect be admissible to negate *any* element of the crime, including the voluntariness requirement which the Commission included in its actus reus provisions. WORKING PAPERS, *supra* note 5, at 234.

⁹⁵ 392 U.S. 514 (1968).

⁹⁶ *Id.* at 548-54 (White, J., concurring); *id.* at 565-70 (Fortas, J., dissenting).

⁹⁷ A generation ago the Court in *Leland v. Oregon*, 343 U.S. 790, 800-01 (1952), refused to hold that the "irresistible impulse" test of insanity is "implicit in the concept of order liberty." If *Leland* is still good law (and the relevant dicta in *Powell* do not criticize it), then not every involuntary action caused by mental illness is constitutionally protected from criminal prosecution.

⁹⁸ See note 97 *supra*.

⁹⁹ Consider, for example, the following testimony of Chief Judge David L. Bazelon, Jr.:

Justice Frankfurter told me privately that he intended to make every effort to avoid a Supreme Court ruling on the definition of the "insanity" defense. The matter was too fluid, too susceptible of change, too much oriented to the individual case for a Supreme Court pronouncement to do anything other than misdirect the development of the law in this area.

1975 Hearings, *supra* note 11, at 228-29. See *Greenwood v. United States*, 350 U.S. 366, 376 (1956) (Frankfurter, J.): "Certainly, denial of constitutional power of commitment to

will,"¹⁰⁰ courts may capitalize on two analytical footholds to circumvent the narrow lemon-squeezing interpretation of section 522: (1) the suggestion in some provisions of S. 1 of a concept of culpability broader than mere awareness of conduct, circumstances, and results, and (2) judicial experience with the defense of diminished capacity. Both approaches would enable a reviewing court to broaden the section 522 defense by broadening the concept of *mens rea* in sections 301 and 302 to reflect a larger, less objective concept of culpability. Both lead to revival of an insanity defense similar to existing formulations at the expense of muddying the attempt to articulate an objective view of *mens rea* in sections 301 and 302.

The first approach begins with section 522 itself. If evidence of mental disease or defect is relevant only to establish the absence of a *mens rea* element, then section 522 would seem redundant given sections 301 and 302 and the mistake-of-fact-or-law defense in section 521.¹⁰¹ To avoid the redundancy, it has been argued,¹⁰² one might assume that section 522 has reference to aspects of culpability beyond those reflected in sections 301 and 302, and that the term "mental disease or defect" adds substantively to *mens rea*. The argument is bolstered by the absence of any voluntariness requirement in the conduct sections of S. 1.¹⁰³ A court might infer from this omission either that the draftsmen intentionally abolished involuntariness as a defense, a conclusion creating serious constitutional tensions, or that they meant to transfer considerations of voluntariness to the *mens rea* elements of sections 301 and 302.¹⁰⁴ The latter view would allow the de-

Congress in dealing with a situation like this ought not to rest on dogmatic adherence to one view or another on controversial psychiatric issues."

¹⁰⁰ H. PACKER, *supra* note 1, at 132.

¹⁰¹ S. 1, 94th Cong., 1st Sess. § 521 (1975) provides:

It is a defense to a prosecution under any federal statute that, as a result of ignorance or mistake concerning a matter of fact or law, the defendant lacked the state of mind required as an element of the offense charged. Except as otherwise provided, ignorance or mistake concerning a matter of fact or law does not otherwise constitute a defense.

¹⁰² 1975 *Hearings*, *supra* note 11, at 219 (statement of Chief Judge David L. Bazelon, Jr.).

¹⁰³ See note 24 *supra*.

¹⁰⁴ Section 501 gives the courts authority to infer defenses not specified in S. 1 but forbids expansion of named defenses beyond the limits of the statute. Although the specific language of § 522 would prohibit evidence of mental disease or defect for any purpose other than to negate *mens rea* (e.g., to negate the conduct element in § 102), this language does not prevent a court from reading the *mens rea* provisions (§§ 301-02) more expansively. See generally A. GOLDSTEIN, *supra* note 1, at 207.

fendant to raise the issue of his ability to control his conduct,¹⁰⁵ quite apart from his ability correctly to perceive what he was doing, and to apply evidence of mental disease or defect, through section 522, to the resolution of that issue.

The principal flaw in this approach is the initial assumption of redundancy. If section 522 is redundant, so is the similarly worded section 521 on mistake of fact or law. Yet section 521 does not add substantively to *mens rea*.¹⁰⁶ Furthermore, the draftsmen may have felt section 522 necessary to make explicit their intent to repeal the judicially created insanity defenses now operative in the federal system,¹⁰⁷ just as section 521 clears up judicial differences over the role of mistake of fact or law.¹⁰⁸ Nevertheless, if Congress intends to do no more than to lay down a rule of evidence for the proper scope and relevance of testimony concerning mental disease or defect in a criminal trial, that purpose could be more clearly achieved by adding a clause to sections 301 and 302.¹⁰⁹ To set out such a rule separately, in a subchapter of the statute entitled "Defenses Based on Lack of Culpability"¹¹⁰ is to suggest that the insanity defense has a substance that the Committee's Staff Report disclaims.

¹⁰⁵ Such a construction would also tend to expand current conceptions of the automatism or involuntariness defense which limit it to cases of somnambulism and occasional cases of psychomotor epilepsy. *E.g.*, *Fain v. Commonwealth*, 78 Ky. 183 (1879) (evidence of somnambulism should have been admitted); *Bratty v. Attorney-General*, [1963] A.C. 386 (H.L. 1961) 3 W.L.R. 965 (H.L.) ("involuntariness" does not include involuntariness due to disease of mind unless a disease within limits of *M'Naghten* or automatism (reflex, convulsive, or unconscious or somnambulistic action) is proven).

¹⁰⁶ JUDICIARY COMM. STAFF REPORT, *supra* note 7, at 94. *But see* 1975 Hearings, *supra* note 11, at 228 (statement of Chief Judge David L. Bazelon, Jr.).

¹⁰⁷ Additionally, § 522 codifies the holding of *Davis v. United States*, 160 U.S. 469 (1895) (nonconstitutional common law decision), placing the burden of persuasion beyond a reasonable doubt on the prosecution. Section 522 also purports to focus the jury's (and the expert witness') consideration of evidence of mental disease or defect on the issue of *mens rea*; arguably, current formulations leave the jury at large to do what they will with evidence of insanity.

For existing federal court formulations of the insanity defense, see note 135 *infra*.

¹⁰⁸ See generally W. LAFAYE & A. SCOTT, CRIMINAL LAW 356-69 (1972); Judiciary Comm. Staff Report, *supra* note 7, at 94-97.

¹⁰⁹ Chief Judge David L. Bazelon, Jr., has stated:

I would suggest the following additional explanation be added to clarify such an intent: "Evidence of a mental disease or defect shall be admissible for the purpose of demonstrating that a person was unaware of the factual circumstances of his conduct or of the existence of a risk, and for no other purposes." This additional language should be placed in § 301 and § 522 . . . should be eliminated.

1975 Hearings, *supra* note 11, at 229.

¹¹⁰ The third defense in this subchapter, intoxication (§ 523), is likewise susceptible of two substantially different interpretations. On a narrow reading, it functions like

Nor are certain other S. 1 defenses consistent with the limited concept of culpability suggested by the lemon-squeezing interpretation of section 522. The affirmative defense of duress in section 531, under the heading "Defenses Based on Lack of Volition," exculpates offenders "of reasonable firmness" who are aware of what they are doing but whose powers of control are impeded by the coercion of "another person." Provocation is a simple defense to murder for the "ordinary person,"¹¹¹ having the effect of downgrading the offense to manslaughter.¹¹² Reference to the reasonable or ordinary person in both defenses would presumably preclude their use by one suffering from mental disease or defect except to the extent that the provocation or duress would produce the same reaction in the "reasonable man."¹¹³ And in any event, constitutional concerns may cause courts to balk at an interpretation that permits an offender to be exculpated for an overpowering of the will by human agency or "ordinary" fits of pique but not by mental disease or defect.¹¹⁴

Further inducement to allow the objective view of *mens rea* in sections 301 and 302 to be "pried open" by section 522 comes from state court experience with the defense of diminished capacity. Since practically every American jurisdiction maintains a separate insanity defense along the lines of either *M'Naghten* or the American Law Institute formulation,¹¹⁵ the function of the

mistake of fact or law and the lemon-squeezing interpretation of § 522 to negate the *mens rea* element of "intent" or "knowledge." Section 523, however, precludes the use of the defense to negate a *mens rea* element of recklessness or negligence. As such, § 523 is a limitation of the general defense suggested by §§ 301-02 and not a separate defense. On a broader reading, intoxication, like mental disease or defect, may suggest a notion of culpability broader than that reflected in the objective view of *mens rea*. Like § 522, § 523 can be seen as infusing aspects of the defendant's capacity for judgment and control of his actions into §§ 301-02. See *People v. Hood*, 1 Cal. 3d 444, 458, 462 P.2d 370, 379, 82 Cal. Rptr. 618, 627 (1969):

[A] drunk man is capable of forming an intent to do something simple, such as strike another, unless he is so drunk that he has reached the stage of unconsciousness. What he is not as capable as a sober man of doing is exercising judgment about the social consequences of his acts or controlling his impulses towards antisocial acts.

¹¹¹ S. 1, 94th Cong., 1st Sess. § 1601(b) (1975).

¹¹² *Id.* § 1602(a)(2).

¹¹³ This statement would not be true if a court were to read into the subjective language "in the position of the defendant" the fact of the defendant's mental disease or defect. See note 14 *supra*. See generally A. GOLDSTEIN, *supra* note 1, at 197-98.

¹¹⁴ See notes 85-98 *supra* & accompanying text.

¹¹⁵ MODEL PENAL CODE § 401 (1) (Proposed Official Draft, 1962): "A person is not responsible for criminal conduct if at the time of such conduct as a result of mental

diminished capacity defense is to allow the jury to consider psychological evidence insufficient to exculpate totally for the purpose of downgrading the level of culpability attaching to the defendant's criminal conduct. By its very nature, the defense suggests a notion of culpability broader than mere awareness of conduct, circumstances, and results. Nevertheless, the defense is normally used to negate a *mens rea* element required by the definition of the offense.¹¹⁶ Hence, courts adopting the defense have had to broaden their *mens rea* definitions to encompass more than mere conscious awareness.

California provides the textbook illustrations. In *People v. Gorshen*,¹¹⁷ evidence of "uncontrollable compulsion" was deemed relevant to suggest the absence of malice aforethought, the mental element required for second degree murder, even though such evidence was excludable on the issue of the insanity defense since California had rejected the irresistible impulse test.¹¹⁸ In *People v. Wolff*,¹¹⁹ the first degree murder requirement of a willful, deliberate, and premeditated killing was interpreted to include consideration of the "extent to which this defendant could maturely and meaningfully reflect upon the gravity of his contemplated act."¹²⁰ The purpose of such inquiry was to assess "the quantum of his moral turpitude and depravity."¹²¹ And in *People v. Conley*¹²² the court ruled that a defendant could not be found to have acted with malice aforethought if he were "unable to comprehend his duty to govern his actions in accord with the duty imposed by law."¹²³

To be sure, the *mens rea* elements under review in the above cases are not precisely those set out in sections 301 and 302 of S. 1. But the process that the California courts underwent to adjust what had previously been a primarily objective concept of *mens rea*, rendering it more subjective to accommodate evidence of mental abnormality, is critical to evaluating the likely

disease or defect he lacks substantial capacity either to appreciate the criminality [wrongfulness] of his conduct or to conform his conduct to the requirements of the law." But see *State v. Pike*, 49 N.H. 399 (1870) ("product" test similar to *Durham*).

¹¹⁶ *Dix*, *supra* note 91, at 324-27.

¹¹⁷ 51 Cal. 2d 716, 336 P.2d 492 (1959), noted in 12 STAN. L. REV. 226 (1959).

¹¹⁸ *Id.* at 727, 336 P.2d at 498-99.

¹¹⁹ 61 Cal. 2d 795, 394 P.2d 959, 40 Cal. Rptr. 271 (1964).

¹²⁰ *Id.* at 821, 394 P.2d at 975, 40 Cal. Rptr. at 287 (emphasis in original).

¹²¹ *Id.* at 822, 394 P.2d at 976, 40 Cal. Rptr. at 288.

¹²² 64 Cal. 2d 310, 411 P.2d 911, 49 Cal. Rptr. 815 (1966).

¹²³ *Id.* at 322, 411 P.2d at 918, 49 Cal. Rptr. at 822.

fate of section 522.¹²⁴ The primary advantage of such a process is that, unlike the all or nothing proposition of the separate insanity defense, it permits more refined judgments of an offender's culpability. The primary disadvantage is that to reach such refined judgments, some degree of chaos must be endured as courts struggle to rewrite *mens rea* to harmonize it with modern psychological theory.¹²⁵ Along the way, expert witnesses and trial judges must suffer the indignity of petty intellectual dishonesties as testimony is bent to the demands of materiality and relevance. And, in the end, the process may turn out to be less effective than the separate insanity defense in bringing to the trier of fact all psychological evidence bearing on culpability. As Professor Dix has noted of the California experience: "Despite the effort the court has expended, it has gone no further than to develop the cognitive aspects of the state of mind requirements. . . . It does not . . . provide a satisfactory vehicle for doctrinal analysis of more complex and sophisticated problems" ¹²⁶

Thus, judicial construction could transform section 522 into a cross between *M'Naghten* and *Durham*—the former because of the emphasis on cognition in Sections 301 and 302,¹²⁷ the latter because the issue of mental illness negating a mental element so closely resembles the *Durham* issue of productivity.¹²⁸ Such a course will surely thwart the draftsmen's hopes of removing psychiatrists from the courtroom¹²⁹ and is unlikely to improve communication among judge, expert witness, and jury. Nor does it begin to resolve the principal problem plaguing the insanity defense today, that of "expert dominance."¹³⁰ By insisting on a factual finding of mental disease or defect, section

¹²⁴ For another example of this process, see *Rhodes v. United States*, 282 F.2d 59 (4th Cir. 1960) (*mens rea* element of knowledge interpreted to include "capacity to know," on which psychiatric evidence deemed relevant).

¹²⁵ For evidence of this chaos and the highly subjective decisions that may result, compare the majority and dissenting opinions in *People v. Goedecke*, 65 Cal. 2d 850, 423 P.2d 777, 56 Cal. Rptr. 625 (1967).

¹²⁶ Dix, *supra* note 91, at 331. For a discussion of the California experience in modifying *mens rea* definitions, see *id.* 328-32.

¹²⁷ The California experience emphasizing cognitive aspects of mental capacity must be evaluated in the context of a parallel full insanity defense derived from *M'Naghten*. The absence of a separate S. 1 insanity defense could conceivably lead the federal courts to view *mens rea* even more subjectively than the California courts.

¹²⁸ See note 12 *supra*.

¹²⁹ See notes 47-53 *supra* & accompanying text.

¹³⁰ 1974 *Hearings*, *supra* note 11, at 224 (statement of Chief Judge David L. Bazelon, Jr.).

522 perpetuates our modern tradition of asking medical experts to resolve for us the moral and legal issue of criminal responsibility.¹³¹

IV. ALTERNATIVES

In urging the abolition of a separate insanity defense, Dean Morris observed, "It too often is overlooked that one group's exculpation from criminal responsibility confirms the inculpation of other groups."¹³² That simple perception provides as well the principal justification for retention of the defense. For it is through the on-going, case-by-case process of exculpating the non-responsible that society evolves its concepts of individual autonomy and accountability. As long as we retain our commitment to the political ideal that an individual is able in some degree to control his own destiny, we shall resist efforts to eliminate our principal mechanism for testing that capacity in our criminal law.¹³³ If we abolish in large measure the defense of blamelessness, we detract from our ability to impose blame. The number of offenders so exculpated is likely to remain small; they are the exception we use to prove the rule of personal accountability. Symbolically, their significance outstrips the social gains to be realized by submitting them to our largely ineffective correctional process.

What, then, should Congress do about the insanity defense? There is little to be gained by adopting the recommendation of the Brown Commission.¹³⁴ Because virtually every circuit has adopted a close facsimile of that test¹³⁵ and because it fails to

¹³¹ See *id.*; Ennis & Litwack, *Psychiatry and the Presumption of Expertise: Flipping Coins in the Courtroom*, 62 CALIF. L. REV. 693 (1974); note 53 *supra*.

¹³² Morris, *supra* note 1, at 520.

¹³³ See A. GOLDSTEIN, *supra* note 1, at 223-26; 1973 *Hearings, supra* note 12, at 6378-79 (statement of Prof. Abraham S. Goldstein).

¹³⁴ Report of the National Comm'n on Reform of Federal Criminal Laws, *Hearings Before the Subcomm. on Criminal Laws and Procedures of the Senate Comm. on the Judiciary*, 92d Cong., 1st Sess., pt. 1, at 194 (1971):

§ 503. Mental Disease or Defect

A person is not responsible for criminal conduct if at the time of such conduct as a result of mental disease or defect he lacks substantial capacity to appreciate the criminality of his conduct or to conform his conduct to the requirements of law. "Mental disease or defect" does not include an abnormality manifested only by repeated criminal or otherwise antisocial conduct. Lack of criminal responsibility under this section is a defense.

¹³⁵ See *United States v. Brawner*, 471 F.2d 969, 979-85 (D.C. Cir. 1972); *Wade v. United States*, 426 F.2d 64, 71-73 (9th Cir. 1970); *Blake v. United States*, 407 F.2d 908, 915-16 (5th Cir. 1969); *United States v. Smith*, 404 F.2d 720, 727 (6th Cir. 1968); *United*

answer the principal criticisms of the insanity defense respecting expert dominance and the illogical strictures of the medical model, legislation would achieve no more than to curtail what limited experimentation exists today. Indeed, one may doubt any special competence of a legislative body, dealing with the issue on an abstract level, to formulate a "test" of criminal responsibility. The better forum for evolving our notions of personal accountability and measuring them against our developing knowledge of human behavior may be, as Judge Bazelon has argued, individual cases.¹³⁶ For it is the individual case which provides us with bits and pieces of the knowledge we now lack. And it is the jury, subject to judicial guidance, which, when face to face with the power to decide the fate of the accused before them, may be society's most efficacious representative in drawing the moral line. The first option, then, is for Congress to stay its hand, to provide procedures for raising a defense of lack of criminal responsibility,¹³⁷ but to leave the substantive "test" to the common law.

A second option would be to clear away the obstacles of expert dominance and the medical model which now encumber full jury consideration of the responsibility issue. Judge Bazelon's suggested jury instruction represents one such formula: "[A] defendant is not responsible *if at the time of his unlawful conduct his mental or emotional processes or behavior controls were impaired to such an extent that he cannot justly be held responsible for his act.*"¹³⁸ Like the option of doing nothing, this option leaves the law of criminal responsibility free to develop with judicial experience.¹³⁹ In addition, it enhances that development by re-

States v. Chandler, 393 F.2d 920, 926-27 (4th Cir. 1968); United States v. Shapiro, 383 F.2d 680, 684-87 (7th Cir. 1967); Pope v. United States, 372 F.2d 710, 735-36 (8th Cir. 1967), *vacated and remanded on other grounds*, 392 U.S. 651 (1968); United States v. Freeman, 357 F.2d 606, 622-24 (2d Cir. 1966); Wion v. United States, 325 F.2d 420, 430 (10th Cir.), *cert. denied*, 377 U.S. 946 (1963); United States v. Currens, 290 F.2d 751, 774 & n.32 (3d Cir. 1961).

¹³⁶ 1975 Hearings, *supra* note 11, at 226-28 (statement of Chief Judge David L. Bazelon, Jr.).

¹³⁷ See, e.g., S. 1, 94th Cong., 1st Sess. §§ 3612(a), 3617 (1975).

¹³⁸ United States v. Brauner, 471 F.2d 969, 1032 (D.C. Cir. 1972) (Bazelon, C.J., concurring and dissenting).

¹³⁹ Appellate supervision of the "justly responsible" test would be altered to the extent that appellate courts would no longer be able to base their rulings upon formal definitions of "mental disease or defect." Additionally, the test suggests greater deference to a properly instructed jury's determination of community standards of blameworthiness. Whether such a test renders the definition more lawless depends on one's perception of the operation of existing insanity defense formulations. If the element of "mental

moving the distraction of determining whether a defendant's condition may properly be termed "mental disease or defect" and concomitantly reducing the jury's dependence on expert witnesses. It tells the jury that mental processes are at issue without requiring a particular medical diagnosis. Finally, it focuses jury attention on what must be the central issue: the balance to be struck between moral blameworthiness and the concerns of social order.¹⁴⁰

Neither option addresses the important practical issue of what is to be done with an offender acquitted for non-responsibility and perceived as mentally ill and a continuing threat to others. But that issue should be analytically distinct from the issue of responsibility irrespective of the legal test employed.¹⁴¹ Preventive confinement addresses future conduct: Past conduct is relevant only as a factor for prediction. Whether or not a jury found the actor criminally responsible for such past conduct is otherwise irrelevant to a determination of preventive confinement.¹⁴² Indeed, one hidden benefit of the second option, the "justly responsible" test,¹⁴³ may be that it will force us to confront the real issues in preventive confinement which now lie masked behind the "special verdict" of "not guilty by reason of insanity."¹⁴⁴

disease or defect" in current formulations is simply an excuse for the expert witness to inject into the record personal judgments on the ultimate issue of responsibility, *see* note 131 *supra*, then current practice may be as insulated from appellate scrutiny as the "justly responsible" approach.

¹⁴⁰ 1975 *Hearings*, *supra* note 11, at 226 (statement of Chief Judge David L. Bazelon, Jr.). This standard has also been suggested as the most appropriate way to deal with psychological evidence that might warrant a finding of diminished capacity but not total exculpation. *See* Dix, *supra* note 91, at 333-34.

¹⁴¹ *See* note 56 *supra*.

¹⁴² Lack of capacity to control given conduct in one set of circumstances does not necessarily imply lack of capacity to control other conduct in other circumstances. For one thing, the underlying mental disability may have undergone spontaneous remission. For another, the disordered thinking may be limited to one particular deed, as when one spouse kills another believing the victim to be the devil.

¹⁴³ *See* text accompanying notes 138-40 *supra*.

¹⁴⁴ Such is the terminology employed in S. 1, 94th Cong., 1st Sess. § 3612(b) (1975).

University of Pennsylvania Law Review

FOUNDED 1852

Formerly
American Law Register

BOARD OF OFFICERS

NANCY J. BREGSTEIN, *Editor-in-Chief*
K. LAYNE MORRILL, *Executive Editor*
JAMES J. SANDMAN, *Executive Editor*
RICHARD M. BERNSTEIN, *Research and Writing Editor*
MICHAEL J. EHRLING, *Article Editor*
GAIL P. GRANOFF, *Comment Editor*
JOSEPH L. LINCOLN, *Article Editor*
WILLIAM P. MURPHY, *Comment Editor*
DANIEL O'DONNELL, *Article Editor*
MARTIN D. POLLACK, *Comment Editor*
LAWRENCE V. STEIN, *Comment Editor*

Editors

MICHAEL BARRON
SUSAN K. BLUMENTHAL
CAROL A. CICHOWSKI
LEONARD J. COLAMARINO
CHERYL A. CRANDALL
JOSEPH S. FINKELSTEIN

ERIC L. FRANK
PAUL A. KAPLAN
RICHARD E. LEVINE
MARY A. McLAUGHLIN
MAURY J. MECHANICK

THOMAS E. PITTS, JR.
MICHAEL T. SCOTT
JEROME B. SIMANDLE
DARIUS D. TENCZA
ANNETTE WHEELER
THOMAS E. ZEMAITIS

Associate Editors

ALAN L. BELLER
RICHARD A. CROWLEY
MARK R. DISLER
BRUCE A. EISENBERG
WILLIAM V. ENGLIS
LAWRENCE FINKELSTEIN
SAMUEL M. FORSTEIN
KENNETH STUART GALLANT
JOSEPH E. GANGLOFF, JR.
LEWIS I. GANTMAN

BRUCE R. GENDERSON
EDWARD I. HANDELMAN
BARBARA RUTH HAUSER
KEITH T. HOLMES
CURTIS E. A. KARNOW
RICHARD L. KORNBLITH
STEVEN KUNEY
LAWRENCE B. KURLAND
MARVIN R. KWARTLER
EDWARD J. LENTZ
ERIC B. LEVINE

RICHARD ALLAN MATASAR
PHILIP ROSENBAACH
GARY L. SASSO
JASON M. SHARGEL
TIMOTHY K. SHUBA
MICHAEL W. STEINBERG
ERICA L. SUMMERS
JOHN A. TERRILL II
RANDOLPH W. TRITELL
ALEXANDER S. WHITE

NINA GOMEZ, *Office Manager*

The endowment of the Morris Wolf Law Review Fund provides financial support for the Law Review.

COMMENT

PRIVATE SCHOOL DESEGREGATION UNDER SECTION 1981

The practice of segregation in private schools vividly presents the conflict between claimed personal rights of privacy and free association on the one hand and the rights guaranteed and enforced by the thirteenth amendment¹ and section 1981 of title 42 of the United States Code² on the other. Two recent suits against segregated private schools under section 1981, *McCrary v. Runyon*³ and *Riley v. Adirondack Southern School for Girls*,⁴ reveal the need for a reexamination of the scope of that section.

Section 1981, formerly section 1 of the Civil Rights Act of 1866,⁵ provides in part that "[a]ll persons . . . shall have the same

¹ U.S. CONST. amend. XIII provides:

"Section 1. Neither slavery nor involuntary servitude, except as a punishment for crime whereof the party shall have been duly convicted, shall exist within the United States, or any place subject to their jurisdiction.

Section 2. Congress shall have power to enforce this article by appropriate legislation."

² 42 U.S.C. § 1981 (1970) provides:

All persons within the jurisdiction of the United States shall have the same right in every State and Territory to make and enforce contracts, to sue, be parties, give evidence, and to the full and equal benefit of all laws and proceedings for the security of persons and property as is enjoyed by white citizens, and shall be subject to like punishment, pains, penalties, taxes, licenses, and exactions of every kind, and to no other.

³ 515 F.2d 1082 (4th Cir. 1975) (en banc), *aff'g in relevant part* *Gonzales v. Fairfax-Brewster School, Inc.*, 363 F. Supp. 1200 (E.D. Va. 1973), *cert. granted*, 96 S. Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306). [Both the district and circuit court decisions hereinafter cited as *McCrary*.]

The district court opinion has been widely commented upon. See Note, *Desegregation of Private Schools: Section 1981 as an Alternative to State Action*, 62 GEO. L. J. 1363 (1974) [hereinafter cited as *Alternative to State Action*]; Note, *The Desegregation of Private Schools: Is Section 1981 the Answer?*, 48 N.Y.U.L. REV. 1147 (1973) [hereinafter cited as *Is Section 1981 the Answer?*]; Comment, *Jones v. Alfred H. Mayer Co. Extended to Private Education: Gonzales v. Fairfax-Brewster School, Inc.*, 122 U. PA. L. REV. 471 (1973) (favoring decision on state action ground) [hereinafter cited as *Private Education*]; 11 HOUSTON L. REV. 691 (1974); 18 HOW. L. J. 458 (1974); 7 LOYOLA U.L. REV. 634 (1974); 45 MISS. L.J. 246 (1974) (favoring reversal); 10 TULSA L.J. 292 (1974); 42 U. CIN. L. REV. 767 (1973); 8 U. RICHMOND L. REV. 285 (1974); 26 VAND. L. REV. 1307 (1973).

⁴ 368 F. Supp. 392 (M.D. Fla. 1973), *appeal docketed*, No. 74-1976, 5th Cir., Apr. 15, 1974.

⁵ Civil Rights Act of 1866, ch. 31, 14 Stat. 27, *reenacted*, Enforcement Act of 1870, ch. 114, § 18, 16 Stat. 144.

right . . . to make and enforce contracts . . . as is enjoyed by white citizens”⁶ The section was enacted by Congress pursuant to its authority under the thirteenth amendment to outlaw slavery. It is unclear how far section 1981 extends, and, in particular, whether the section outlaws private school segregation.⁷ If the section is construed to prohibit such segregation, as it was in *McCrary*, Congress may have exceeded its power to enforce the amendment by infringing constitutional rights to privacy and freedom of association, as guaranteed by the first amendment. This Comment will consider the significance of the claim, raised in both *McCrary* and *Riley*, that racial discrimination in private school admissions is a constitutionally protected activity.⁸ The recent Fifth Circuit decision in *Cook v. Hudson*⁹ will be considered in evaluating the constitutional interest, if any, in segregated private schools.¹⁰

The Comment will conclude that section 1981 as currently interpreted may constitutionally be applied to private schools. This Comment will also propose, however, a new interpretation of the section, somewhat analogous to the theory of mitigation of damages, which would strengthen the case for applying the statute to private schools by not denigrating vital associational

⁶ 42 U.S.C. § 1981 (1970).

⁷ Much of the debate about the revival of § 1981 and its companion, 42 U.S.C. § 1982 (1970), revolves around the legislative history of these and other civil rights laws. See, e.g., *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409 (1968) (compare majority with dissenting opinions). This Comment will for the most part ignore the historical approach to interpretation of the statutes, in part because of adequate coverage elsewhere, and in part because the use of legislative history in this context is often not helpful when used only as a makeweight after evaluation of other issues.

⁸ See generally Note, *Section 1981 and Private Groups: The Right to Discriminate Versus Freedom from Discrimination*, 84 YALE L.J. 1441 (1975). Some commentators have suggested that the proper method for attacking private school segregation is through use of a state action-public function analysis, e.g., Note, *Segregation Academies and State Action*, 82 YALE L.J. 1436 (1973) [hereinafter cited as *Academies*]; *Private Education*, *supra* note 3. These articles adequately cover most of the strengths and weaknesses of this approach. This Comment will not discuss the state action analysis, in part because of the prior treatment and in part because state action was not an issue actually addressed in the *McCrary* and *Riley* litigations. The shortcomings of the state action theory are most graphically set forth in *Alternative to State Action*, *supra* note 3, at 1366-69.

⁹ 511 F.2d 744 (5th Cir.), *aff'g* 365 F. Supp. 855 (N.D. Miss. 1973), *petition for cert. filed*, 44 U.S.L.W. 3230 (U.S. Oct. 1, 1975) (No. 75-503).

¹⁰ The district court opinion is commented upon in Comment, *Cook v. Hudson: The State's Interest in Integration Versus the First Amendment Rights of the Public Schoolteacher*, 45 MISS. L.J. 953 (1974) (favoring reversal); 6 N.C. CENT. L.J. 107 (1974). Text accompanying notes 101-15 *infra*. In *Hudson*, a divided court upheld a school board policy against hiring or rehiring teachers whose children attend private school. The school board adopted this policy to reinforce a court-ordered program of desegregation of the public school system. The case presents a variation of the conflict between asserted first amendment rights and rights to racial equality.

and privacy rights which might be infringed by an unlimited application of section 1981. Section 1981 may be limited by requiring that the plaintiffs show actual injury in the market for education because of racial discrimination by the defendants; if alternative equivalent education is obtainable, no violation of section 1981 should be found. While section 1981 guarantees to nonwhites the same right to contract as whites, this right should be interpreted in light of the traditional requirement in the law of contracts that real injury in the marketplace be shown.¹¹

I. ATTACKS UPON PRIVATE SCHOOL SEGREGATION:

MCCRARY AND RILEY

In *Gonzales v. Fairfax-Brewster School, Inc.*,¹² it was alleged that two black children were denied admission to defendant private schools because of their race in violation of section 1981. The district court, finding that the schools' admissions policies reflected "no 'plan or purpose of exclusiveness' for selection of students 'other than race'," ¹³ awarded damages for plaintiffs' humiliation and enjoined defendants from practicing racial discrimination in admissions in the future.¹⁴

The Court of Appeals for the Fifth Circuit affirmed in *McCrary v. Runyon*.¹⁵ Chief Judge Haynsworth wrote: "The section is violated by the school as long as the basis of exclusion is racial, for then it is clear that the black applicant is denied a contractual right which would have been granted to him if he had been white."¹⁶ At defendants' schools, there was a class of qualified applicants defined by "academic, financial, and other restrictions upon admission," but "[w]ithin the qualified class . . . there is no other limitation upon the admission of white applicants up to the school's capacity."¹⁷ That some whites were out-

¹¹ See, e.g., A. CORBIN, *CONTRACTS* §§ 1039-44 (1964).

¹² 363 F. Supp. 1200 (E.D. Va. 1973), *aff'd in relevant part sub nom. McCrary v. Runyon*, 515 F.2d 1082 (4th Cir. 1975) (en banc), *cert. granted*, 96 S. Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306).

¹³ 363 F. Supp. at 1204 (quoting *Sullivan v. Little Hunting Park, Inc.*, 396 U.S. 229, 236 (1969), which established that a private group that is not a "private club" under Title II of the 1964 Civil Rights Act, 42 U.S.C. § 2000a *et seq.* (1970), is not exempt from 42 U.S.C. § 1982 (1970)).

¹⁴ The injunction applied not only to the named defendant but also to the Southern Independent School Association, an intervening defendant. This Association alleged that it represents "over 300 private, non-profit schools in the South, some of which concededly are racially exclusive in their admission policies." 515 F.2d at 1084.

¹⁵ 515 F.2d 1082 (4th Cir. 1975) (en banc), *cert. granted*, 96 S. Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306).

¹⁶ 515 F.2d at 1087.

¹⁷ *Id.*

side that class did not "undo" the section 1981 violation, the court reasoned, because the Supreme Court had found violations of section 1982,¹⁸ whose scope closely parallels that of section 1981, in the segregation of private clubs that admitted all white persons up to the clubs' capacity.¹⁹

Judge Haynsworth disposed of the defendants' claim to associational and privacy rights by pointing out that the schools were free to teach whatever doctrines and to use whatever methods they wished.²⁰ Moreover, these private groups could legitimately apply non-racial restrictions on admission, even if a racial imbalance in the student population resulted. The schools could not discriminate on the basis of race, however,²¹ notwithstanding the Supreme Court's speculation in *Norwood v. Harrison* that the "Constitution may compel toleration of private discrimination"²²

The dissenting judges in *McCrory* made two important arguments. First, Judge Russell asserted that "[t]he right to make and enforce contracts does not imply a right to coerce an unwilling co-contractor into making any and every variety of contract."²³ In his view, *Moose Lodge No. 107 v. Irvis*,²⁴ in which the right of a private club to discriminate was upheld even though it possessed a state liquor license, indicated that the unwilling co-contractor has the right to discriminate when important personal preferences are involved. Second, the dissent urged that the contractual features of application for admission to the defendant private schools were quite insubstantial so that the right to contract was in effect a pretense, a mere "door opener," to enable a court to reach the desired result.

Without endorsing the right of private schools to discriminate in admissions, the court in *Riley v. Adirondack Southern School for Girls*²⁵ suggested a somewhat narrower application of section 1981 than did the *McCrory* majority. In *Riley* the plaintiff sought

¹⁸ 42 U.S.C. § 1982 (1970) provides: "All citizens of the United States shall have the same right in every State and Territory, as is enjoyed by white citizens thereof to inherit, purchase, lease, sell, hold, and convey real and personal property."

¹⁹ *Tillman v. Wheaton-Haven Recreation Ass'n*, 410 U.S. 431 (1973); *Sullivan v. Little Hunting Park, Inc.*, 396 U.S. 229 (1969).

²⁰ 515 F.2d at 1087. The court relied on *Pierce v. Society of Sisters*, 268 U.S. 510 (1925).

²¹ 515 F.2d at 1088.

²² 413 U.S. 455, 463 (1973).

²³ 515 F.2d at 1093 (Russell, Field & Widener, JJ., dissenting).

²⁴ 407 U.S. 163 (1972).

²⁵ 368 F. Supp. 392 (M.D. Fla. 1973), *appeal docketed*, No. 74-1976, 5th Cir., Apr. 15, 1974.

to enroll her black daughter in a private, all-white girls' school in Florida. The district court was "not persuaded that, but for her race the Plaintiff's child would have been accepted."²⁶ Therefore, while the court found that the evidence as a whole strongly suggested that race was one factor in the applicant's rejection, it denied relief.²⁷

Both *Riley* and the dissent in *McCrory* tend to limit the application of section 1981 in suits against private segregated schools. In *McCrory* the dissent found a right in private schools to discriminate racially in their admissions process because of privacy and associational interests, and in *Riley* the court relied on a restrictive definition of causation. Neither case was actually decided on the basis of the claimed associational and privacy interests. These interests warrant closer examination as they are crucial to the formulation of more rational principles of construction for section 1981.

II. SECTION 1981 AND ASSOCIATIONAL AND PRIVACY RIGHTS: AN OVERVIEW

The law of section 1981, of privacy, and of association have not yet been effectively synthesized. Before a synthesis can be attempted, some overview of the areas is necessary.

A. *The Right to Make and Enforce Contracts under Section 1981*

Two principal theories of the meaning of the phrase "the same right . . . to make and enforce contracts"²⁸ have been expressed in the cases and the literature.

²⁶ 368 F. Supp. at 395. On appeal, plaintiff-appellant will argue that the other reasons for rejecting her child were subterfuges for race, and that any other finding would be clearly erroneous. Brief for Appellant at 1.

²⁷ 368 F. Supp. at 395.

Riley may be consistent with *McCrory* in that the plaintiff in *Riley* failed to meet non-racial standards established by the school. By applying *McCrory's* analysis, *Riley* need only have held that a violation of § 1981 occurs when a party is denied an opportunity to make a contract that he could have made had he been white, but that when racial bias may have been only incidentally appeased, no violation of § 1981 can be found. Indeed *Riley* itself states that "[u]nless it can be shown that, but for race the complainant would have succeeded [in making a contract], there is no denial of rights assured by § 1981." *Id.* at 398. A § 1981 action can succeed only when race is found to be the sole element in the rejection of a student applicant. This explains why the court disregarded its finding that racial bias played a part in the decision to reject the applicant.

If, on the other hand, appellant in *Riley* is correct in asserting that race was the only factor in the decision to reject, the other factors being a subterfuge, then affirmance of the district court would be inconsistent with *McCrory*.

²⁸ 42 U.S.C. § 1981 (1970).

An early interpretation of the scope of section 1981 was given in *Hodges v. United States*.²⁹ That case arose when a group of white men resorted to violence to prevent certain blacks from securing employment in a sawmill. The Supreme Court reversed the criminal conspiracy convictions which had been based on the violation of section 1981 rights, indicating that the acts of intimidation did not impose a condition of slavery upon their victims. Having reached this conclusion, the Court proceeded to describe the intended scope of section 1981 in terms of prohibition of government-imposed restrictions upon an individual's capacity to make contracts.³⁰

This interpretation of section 1981 has been dealt three blows that must by now be deemed mortal. In *Jones v. Alfred H. Mayer Co.*,³¹ a suit based on section 1982, defendant refused for reasons of race to sell a house to a prospective buyer who was black. The Supreme Court held that section 1982 reaches private discrimination and observed that section 1981 also applies to private discrimination, overruling *Hodges* to the extent of inconsistency.³² In *Tillman v. Wheaton-Haven Recreation Association*,³³ the Court again indicated that section 1981 is applicable to private dealings, but did not define the scope of that application. The demise of the state involvement approach was confirmed recently in *Johnson v. Railway Express Agency, Inc.*, a suit in which plaintiff alleged employment discrimination under section 1981. The Supreme Court affirmed that section 1981 "affords a federal remedy against discrimination in private employment on the basis of race."³⁴ Clearly the approach taken before *Jones v. Alfred H. Mayer Co.* to interpreting "right to contract" can no longer serve as the basis for interpretation of this statute.³⁵

²⁹ 203 U.S. 1 (1906).

³⁰ *Id.* at 17-18. This was the traditional approach to interpretation of "right to contract." See, e.g., *Lincoln Federal Labor Union v. Northwestern Iron & Metal Co.*, 335 U.S. 525, 533-34 (1949); *Lochner v. New York*, 198 U.S. 45, 53-55 (1905); *Allgeyer v. Louisiana*, 165 U.S. 578, 590-91 (1897) (cases representing both sides of the "economic substantive due process" debate). See also *California Drive-in Restaurant Ass'n v. Clark*, 22 Cal. 2d 287, 295, 140 P.2d 657, 662 (1943); *Mathewson v. Mathewson*, 79 Conn. 23, 24-26, 63 A. 285, 286-87 (1906); *Elder Chevrolet Co. v. Bailey County Motor Co.*, 151 S.W.2d 938, 942 (Tex. Civ. App. 1941).

³¹ 392 U.S. 409 (1968). See also *Sullivan v. Little Hunting Park, Inc.*, 396 U.S. 229 (1969) (damage remedy for violation of § 1981).

³² *Id.* at 441 n.78.

³³ 410 U.S. 431 (1973).

³⁴ 95 S. Ct. 1716, 1720 (1975).

³⁵ For a discussion of this theory and its demise, see *Alternative to State Action*, *supra* note 3, at 1370-73 & sources cited in *id.* 1370 n.33.

The holdings in *McCrary*³⁶ and *Riley*³⁷ illustrate the second major approach to section 1981, predominant since *Jones*, in holding that the section is violated when a nonwhite cannot make a contract he could have made had he been white. The novelty of these holdings lies only in their application to completely private schools.³⁸ Several courts of appeals had reached similar results prior to *McCrary* and *Riley* in several cases involving employment contracts³⁹ and in a case involving a privately owned recreation area.⁴⁰ As noted above, the Supreme Court held in *Johnson v. Railway Express Agency, Inc.* that section 1981 applies to private discrimination in employment.⁴¹ But the Court there had no occasion to endorse or reject the standard ultimately articulated in *McCrary* and *Riley* defining violation of section 1981. There is, however, nothing in *Johnson* to indicate a more restrictive interpretation.

This more recent line of reasoning is quite expansive. Section 1981 so interpreted applies to the entire body of relationships that may be defined as contractual. Whether the relationship is business or personal is not, according to this view, important.⁴² This interpretation may be limited by strict definition of what is a contract. For example, the Court of Appeals for

³⁶ *McCrary v. Runyon*, 515 F.2d 1082 (4th Cir. 1975) (en banc), cert. granted, 44 U.S.L.W. 3279 (U.S. Nov. 11, 1975) (Nos. 75-62, 75-66, 75-278, 75-306).

³⁷ *Riley v. Adirondack Southern School for Girls*, 368 F. Supp. 392 (M.D. Fla. 1973), appeal docketed, No. 74-1976, 5th Cir., Apr. 15, 1974.

³⁸ The schools in these suits received no government funding nor special favors. Section 1981 had already been applied to a private trade school in *Grier v. Specialized Skills, Inc.*, 326 F. Supp. 856 (W.D.N.C. 1971), but the court there held that the fact that the trade school had to be licensed by the state and that all such state-licensed schools were segregated (two out of five all black) impermissibly involved the state in the affairs of the school. Further, some of the school's students received federal aid.

³⁹ *Long v. Ford Motor Co.*, 496 F.2d 500 (6th Cir. 1974); *Brown v. Gaston County Dyeing Mach. Co.*, 457 F.2d 1377 (4th Cir.), cert. denied, 409 U.S. 982 (1972); *Young v. International Tel. & Tel. Co.*, 438 F.2d 757, 758-60 (3d Cir. 1971); *Boudreaux v. Baton Rouge Marine Contracting Co.*, 437 F.2d 1011, 1016-17 (5th Cir. 1971) (following *Sanders v. Dobbs Houses, Inc.*, 431 F.2d 1097, 1099-1100 (5th Cir. 1970), cert. denied, 401 U.S. 948 (1971)); *Waters v. Wisconsin Steel Works*, 427 F.2d 476, 481-84 (7th Cir.), cert. denied, 400 U.S. 911 (1970).

⁴⁰ *Scott v. Young*, 421 F.2d 143 (4th Cir.), cert. denied, 398 U.S. 929 (1970) (alternate holding); see *Olzman v. Lake Hills Swim Club*, 495 F.2d 1333 (2d Cir. 1974) (swimming club's rules were alleged to be racial subterfuges).

⁴¹ 95 S. Ct. 1716, 1720 (1975). *Johnson* held that § 1981 is a remedy for job discrimination entirely separate from Title VII of the 1964 Civil Rights Act, 42 U.S.C. § 2000e et seq. (1970), and that therefore an action in the Equal Employment Opportunity Commission under that title does not toll the statute of limitations applicable to § 1981.

⁴² But see Buchanan, *Federal Regulation of Private Racial Prejudice: A Study of Law in Search of Morality*, 56 Iowa L. Rev. 473, 506-12 (1971).

the Fifth Circuit held in *Cook v. Advertiser Co.*⁴³ that a standing opportunity to publish social notices in a newspaper, without charge, does not amount to an offer of a unilateral contract, so that one denied publication on racial grounds has no cause of action under section 1981. Neither whites nor blacks, the court reasoned, can claim a contract right to have notices published.⁴⁴

Apart from *McCrary*, only district courts have considered the right of privacy as a principle possibly limiting section 1981.⁴⁵ A reason for limiting application of the section is to prevent the danger, somewhat overstated by the *McCrary* dissenters, that unwilling co-contractors will be coerced into any and every variety of contract,⁴⁶ thus changing the effective definition of contract from a meeting of the minds (subject to legitimate government regulation) to a meeting of the minds on all subjects except race.⁴⁷ The logic of this line of reasoning has been considered by many commentators⁴⁸ and will be discussed below in terms of the conflict between section 1981 and first amendment and related constitutional liberties.

B. Associational and Privacy Rights

The Supreme Court has never addressed itself to the problem of clearly defining or even stating a formula for associational

⁴³ 458 F.2d 1119 (5th Cir. 1972), *aff'd* 323 F. Supp. 1212 (M.D. Ala. 1971).

⁴⁴ For purposes of this Comment, Judge Wisdom's concurring opinion is more interesting than the majority opinion. Judge Wisdom's conclusion that the Advertiser's solicitation of information about social events and responses to that solicitation did not constitute a contract was

shaped by, if not compelled by, the First Amendment's guarantee of a free press. It is most unlikely that any court in our land could constitutionally enforce a promise by a newspaper to publish any particular item of news [citing *Shelley v. Kraemer*, 334 U.S. 1 (1948)]. Even if a newspaper stooped to sell its news coverage for hard cash, I suppose the most a frustrated buyer would be entitled to would be a refund of the dollars he had parted with.

458 F.2d at 1123 (Wisdom, J., concurring). *But see* *Pittsburgh Press Co. v. Pittsburgh Comm'n on Human Relations*, 413 U.S. 376 (1973) ("commercial speech," here in the form of sex-segregated want ads, not protected by the first amendment) (5-4 decision, Burger, C.J., and Douglas, Stewart and Blackmun, JJ., dissenting).

⁴⁵ See, e.g., *Cornelius v. Benevolent Protective Order of Elks*, 382 F. Supp. 1182, 1198 (D. Conn. 1974) (§ 1981 found unconstitutional if read with no limits, but "saved" by "harmonization" with the private club exemption of Title II of the 1964 Civil Rights Act, 42 U.S.C. § 2000a(e) (1970), by exempting private clubs from § 1981 as well); *Sims v. Order of United Commercial Travelers*, 343 F. Supp. 112 (D. Mass. 1972).

⁴⁶ Text accompanying note 23 *supra*.

⁴⁷ Of course, it can be said that any limitation on power to bargain inserts an element of unwillingness into the subsequent deal. Cf. *Lochner v. New York*, 198 U.S. 45 (1905); *Allgeyer v. Louisiana*, 165 U.S. 578 (1897) (discredited "substantive due process" cases).

⁴⁸ E.g., Buchanan, *supra* note 42; Note, *Federal Power to Regulate Private Discrimination: The Revival of the Enforcement Clauses of the Reconstruction Era Amendments*, 74 COLUM. L.

and privacy rights. The following will point out those decisions that may be useful in synthesizing a definition of these rights needed to dispose of the cases at hand.

1. The Right of Association⁴⁹

Except for "the right of the people peaceably to assemble, and to petition the Government for a redress of grievances,"⁵⁰ freedom of association is not specifically set forth in the Constitution. The development of associational rights in the Supreme Court has been largely dependent on the kind of situation in which the issue has arisen. It is not clear in any given case precisely what considerations the Court will take into account, in developing the doctrine further. The factual settings of *McCrary* and *Riley* have not yet been dealt with by the Court.

At the very least, private schools have a right to exist and to teach whatever subjects and doctrines not "manifestly inimical to the public welfare" they wish.⁵¹ The right to control their own activities is not unlimited, but is susceptible to reasonable regulation concerning the compulsory teaching of certain subjects and the qualifications of teachers.⁵² (Private schools do not, however, have the right to discriminate on the basis of race while receiving federal or state assistance.)⁵³ Whatever additional rights private schools may have must be deduced from decisions regarding associational and privacy rights in other contexts and from general constitutional and ethical principles.

The right to associate for political purposes has been defined broadly and has been given protection in a number of contexts. One case in which the right to associate was raised, *NAACP v. Alabama ex rel. Patterson*,⁵⁴ held that a nonsubversive political organization need not reveal its membership list to the

REV. 449 (1974); *Is Section 1981 the Answer?*, *supra* note 3, at 1153-75; *Private Education*, *supra* note 3.

⁴⁹ See generally C. RICE, *FREEDOM OF ASSOCIATION* (1962); Emerson, *Freedom of Association and Freedom of Expression*, 74 YALE L.J. 1 (1964); Nathanson, *Freedom of Association and the Quest for Internal Security: Conspiracy from Dennis to Dr. Spock*, 65 NW. U.L. REV. 153 (1970).

⁵⁰ U.S. CONST. amend. I.

⁵¹ *Pierce v. Society of Sisters*, 268 U.S. 510, 534 (1925); see *Meyer v. Nebraska*, 262 U.S. 390 (1923); *Bartels v. Iowa*, 262 U.S. 404 (1923) (both striking down statutes forbidding teaching languages to school children of certain ages).

⁵² 268 U.S. at 534.

⁵³ E.g., *Gilmore v. City of Montgomery*, 417 U.S. 556 (1974); *Norwood v. Harrison*, 413 U.S. 455 (1973); *Green v. Connally*, 330 F. Supp. 1150 (D.D.C.), *aff'd per curiam sub nom. Coit v. Green*, 404 U.S. 997 (1971); *Griffin v. County School Bd.*, 377 U.S. 218 (1964).

⁵⁴ 357 U.S. 449 (1958).

government when there is some possibility that doing so would expose some of its members to adverse community pressures and when the state could accomplish its aim in requiring such a list less intrusively. Alabama proposed to use the lists to determine violations of the state's foreign corporation statutes. On the other hand, in *Communist Party v. Subversive Activities Control Board*⁵⁵ the Court upheld the federal government's interest in requiring Communist Party members to register with the government on the basis of a legislative finding that foreign-dominated Communist activities posed a substantial threat to the national security.⁵⁶ Even when one is a member of a subversive organization, however, he must specifically intend to promote such of the organization's aims as are illegal if he is to be penalized.⁵⁷

Important to an analysis of the private school segregation issue is the broad scope that has been given the term "political association." The Supreme Court has not limited the term "political activity" to the narrowly electoral, or even to the promotion of ideology through speech and associated media. *NAACP v. Button*⁵⁸ held that a Virginia antichamperty law could not apply to the NAACP's efforts to secure legal assistance for poor blacks, because of the organization's associational rights.

The NAACP is not a conventional political party; but the litigation it assists, while serving to vindicate the legal rights of members of the American Negro community, at the same time and perhaps more importantly, makes possible the distinctive contribution of a minority group to the ideas and beliefs of our society. For such a group, association for litigation may be the most effective form of political association.⁵⁹

Against this associational right, the state's claimed interest in preventing misuse of the courts could not stand.⁶⁰

⁵⁵ 367 U.S. 1 (1961).

⁵⁶ A subsequent case rendered the registration requirement invalid on the ground that it violated the fifth amendment privilege against self-incrimination. *Albertson v. Subversive Activities Control Bd.*, 382 U.S. 70 (1965). In *Aptheker v. Secretary of State*, 378 U.S. 500 (1964), the denial of passports to Communist Party members who failed to register was invalidated for overbreadth, in part because it could be applied to one who did not know or did not intend the Party's illegal aims.

⁵⁷ See *Elfbrandt v. Russell*, 384 U.S. 11 (1966); *De Jonge v. Oregon*, 299 U.S. 353 (1937).

⁵⁸ 371 U.S. 415 (1963).

⁵⁹ *Id.* at 431.

⁶⁰ Justice Douglas, concurring, noted that the purpose of the law in question was to

An individual may not be punished for teaching a doctrine, even a code of violence, absent a clear and present danger.⁶¹ Presumably an individual or a group may not be punished for banding together to learn such a doctrine or even to spread it. One court of appeals has held that protection of political association requires that segregated political groups be given the same opportunity to use state-owned facilities on a temporarily exclusive basis as is given other political groups.⁶²

Much of the law of free association concerns governmental restrictions on public employees. The leading cases permitting such restrictions, *United Public Workers v. Mitchell*⁶³ and *United States Civil Service Commission v. National Association of Letter Carriers*,⁶⁴ upheld enforcement of the Hatch Act, restricting the right of federal employees to engage in partisan political activities. Other cases, however, have protected the rights of government employees to engage in associational activities that are political in a broad sense of that term but are not partisan in the sense of the dominant two-party system. *United States v. Robel*⁶⁵ held that Congress cannot make it a crime to belong to an officially designated Communist-action organization while working in a defense plant; but the Court conceded that the result might be different if the statute required proof of specific intent to engage in the unlawful activities such an organization might promote.⁶⁶ But absent a strong countervailing governmental interest the right of public employees to associate may not be infringed. This is clear from *Shelton v. Tucker*,⁶⁷ in which the Court held that Arkansas may not require its schoolteachers to file annual affidavits, listing all current and recent organizational ties, for the purpose of assessing the teachers' fitness.

There is also some constitutional protection of social, non-political association, but whether it is as great as protection of

resist the mandate of *Brown v. Board of Educ.*, 347 U.S. 483 (1954) by penalizing the NAACP because it promotes desegregation. *Id.* at 445.

⁶¹ *Brandenburg v. Ohio*, 395 U.S. 444 (1969). Justices Black and Douglas would not recognize a "clear and present danger" exception. *Id.* at 449-57 (Black & Douglas, JJ., concurring).

⁶² *National Socialist White People's Party v. Ringers*, 473 F.2d 1010 (4th Cir. 1973) (en banc) (successor to the American Nazi Party was allowed to rent a public school auditorium, often used for political discussion, for a public meeting and a private meeting, over the objections of the county that this activity would impermissibly involve it in discriminatory action because blacks and Jews were to be excluded).

⁶³ 330 U.S. 75 (1947).

⁶⁴ 413 U.S. 548 (1973).

⁶⁵ 389 U.S. 258 (1967).

⁶⁶ *Id.* at 262-63.

⁶⁷ 364 U.S. 479 (1960).

political association is unclear. The strongest recent support for such rights is provided in two cases concerning appropriate means of implementing desegregation orders. In *Norwood v. Harrison* the Court speculated that "the Constitution may compel toleration of private discrimination" ⁶⁸ However, the Court did not conclude that the Constitution does in fact compel such toleration. ⁶⁹ The Court voiced this concern in *Gilmore v. City of Montgomery*, in refusing to restrict certain uses of public parks by segregated groups: "The freedom to associate applies to the beliefs we share, and to those we consider reprehensible." ⁷⁰ This result was based on the absence of state action, but the Court had in mind potential encroachments upon discriminatory groups' associational rights. Significantly, the Supreme Court has not yet held these rights to include the right to exist as a racially discriminatory group, ⁷¹ although several lower courts have done so. ⁷²

There is a hint, but only a hint, that associational rights do not include a right to associate on the basis of race or, alternatively, that such associations merit less protection than others because of the spirit of the post-Civil War amendments. The *McCrary* opinion states that some schools may be "so private as to have a discernible rule of exclusivity which is inoffensive to § 1981." ⁷³ The principle of exclusivity would have to be racially neutral, however, to be inoffensive, as, for example, if siblings retained a tutor for their children. ⁷⁴

Shelley v. Kraemer ⁷⁵ and *Barrows v. Jackson* ⁷⁶ lend support to the position that segregation is not a protected form of association. A group of people may agree to associate by living together as a community and may use the device of enforceable property covenants to ensure the group's cohesiveness. (For example, covenants requiring that lawns be mowed regularly and houses maintained can be seen as an effort by the co-covenantors to

⁶⁸ 413 U.S. 445, 463 (1973).

⁶⁹ *But see* *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163, 179 (1972) (Douglas, J., dissenting).

⁷⁰ 417 U.S. 556, 575 (1974).

⁷¹ Note that the question of a club's right to exist as a segregated organization is distinct from what rights extent clubs have.

⁷² *See* cases cited note 45 *supra*.

⁷³ *McCrary v. Runyon*, 515 F.2d 1082 (4th Cir. 1975) (en banc), cert. granted, 96 S. Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306).

⁷⁴ 515 F.2d at 1088-89.

⁷⁵ 334 U.S. 1 (1948).

⁷⁶ 346 U.S. 249 (1953).

associate only with people who care about their surroundings.⁷⁷) Race is not a characteristic that the group may use in defining itself, however, if it wishes to enforce a covenant restricting the sale of property. Since *Jones v. Alfred H. Mayer Co.*,⁷⁸ even voluntary cooperation in maintaining a segregated community is impermissible, because a prospective purchaser has a remedy against the discriminatory seller. Indeed, it is possible that the right of association, "penumbral" to begin with, is dimmed further by the post-Civil War amendments. This Comment is concerned with more than the shadowing of the right of association by the post-Civil War amendments; it is concerned with the possibility of the right's total eclipse.

2. The Right of Privacy

Cases defining the growing area of privacy⁷⁹ or what might be described as autonomy⁸⁰ of person and family also contribute to the theory of the rights of private schools. This area was recognized in 1925 in *Pierce v. Society of Sisters*,⁸¹ in which the Court invalidated a state law requiring children to attend public school because the law abridged "the liberty of parents . . . to direct the upbringing and education of [their] children . . ."⁸² The notion has undergone its greatest development in four cases decided in the last decade, *Griswold v. Connecticut*,⁸³ *Stanley v. Georgia*,⁸⁴ *Eisenstadt v. Baird*,⁸⁵ and *Roe v. Wade*.⁸⁶ The principle common to these cases is that certain aspects of one's life are so personal that direct governmental encroachment is constitutionally impermissible.

For purposes of analyzing the privacy problems in the private school setting, *Griswold* is the most important of the four

⁷⁷ Of course this might also evidence a financial concern with maintaining property values.

⁷⁸ 392 U.S. 409 (1968).

⁷⁹ See generally Henkin, *Privacy and Autonomy*, 74 COLUM. L. REV. 1410 (1974); Warren & Brandeis, *The Right to Privacy*, 4 HARV. L. REV. 193 (1890); Symposium—*Privacy*, 31 LAW & CONTEMP. PROB. 251 (1966); Note, *On Privacy: Constitutional Protection for Personal Liberty*, 48 N.Y.U.L. REV. 670, 697-705 (1973) [hereinafter cited as *On Privacy*].

⁸⁰ See notes 142-77 *infra* & accompanying text.

⁸¹ 268 U.S. 510 (1925).

⁸² *Id.* at 534-35.

⁸³ 381 U.S. 479 (1965) (decision to use contraceptives is a penumbral right for married couples).

⁸⁴ 394 U.S. 557 (1969) (right to have pornography in the privacy of one's home).

⁸⁵ 405 U.S. 438 (1972) (equal protection requires that the availability of contraceptives not be dependent on marital status).

⁸⁶ 410 U.S. 113 (1973) (abortion).

decisions because it protects a particular intrafamilial relationship, marriage, from certain governmental interference. The Court in *Griswold* held that the state may not deny to a married couple the right to choose whether or not to use contraceptives.⁸⁷ The Court based its holding on several constitutional principles, primarily the first amendment and its penumbras but also the third, fourth, fifth, ninth, and fourteenth amendments, all of which contain guarantees against governmental interference with various aspects of an individual's life. The majority relied on *Pierce* to support its holding,⁸⁸ suggesting that intrafamilial relationships other than the conjugal one share the same type of protection.

The other three decisions bear less directly on the privacy rights accorded specific family relationships, but do concern the general right of individuals to be free from governmental interference in matters of personal choice, particularly those related to sexuality. In *Stanley v. Georgia*,⁸⁹ the Court held that although publication and sale of pornography may be unprotected by the first amendment, the possession of obscene material for use in the privacy of one's home is protected as part of the right of freedom of thought. In *Roe v. Wade*,⁹⁰ as in *Griswold*, the decision to have a child was considered, this time in light of the woman's particular problems as a childbearer. The private nature of this decision was found to outweigh many state interests previously believed to be of overriding importance. In *Eisenstadt*,⁹¹ the right of unmarried persons to the same freedom of access to contraceptives as that possessed by married people was established.

That these cases do not bear directly on the relationship between parent and child and the decisionmaking aspects of that relationship does not imply that the parent-child relationship is not protected by the Constitution. To the contrary, *Pierce* demonstrates that the relationship is protected and *Griswold*, *Stanley*, *Eisenstadt*, and *Roe v. Wade* reinforce and expand the *Pierce* approach by upholding penumbral rights of privacy in intimate relationships or deeply personal choices.⁹²

⁸⁷ Note that there are limits even to this freedom, for there is little question that contraception may be limited in certain ways, as by prohibition of a harmful drug.

⁸⁸ 381 U.S. at 481-83.

⁸⁹ 394 U.S. 557 (1969).

⁹⁰ 410 U.S. 43 (1973).

⁹¹ *Eisenstadt v. Baird*, 405 U.S. 438 (1972).

⁹² In *Wisconsin v. Yoder*, 406 U.S. 205 (1972), the parent-child relationship was protected against the state's interference in the context of a decision concerning how much education was enough for the child. That decision was based primarily on the right

III. LIMITING PRINCIPLES FOR SECTION 1981

The ultimate resolution of the issues raised in *McCrary* and *Riley* will depend on the limiting principles devised for use in section 1981 cases. This section will deal with several possible principles for limiting the section, raising issues of both statutory and constitutional dimension.

A. The "Door Opener" Argument

The dissenting judges in *McCrary* asserted that in the private school context "[t]he contract aspect of the situation is minor and incidental and serves no purpose other than as a door opener in the present case to bring independent schools within the scope of § 1981."⁹³ This is so, the dissent believed, because the student-teacher relationship is one of status rather than contract and is "related to the contract concept in the same way that the status of husband and wife may be said to grow out of a contract"⁹⁴ These situations were distinguished from that of *Jones v. Alfred H. Mayer Co.*⁹⁵ because the property transactions denied in *Jones* in violation of section 1982 were "purely commercial," with a basis in contract and not in status.⁹⁶

It is clear, however, that there is a more than token contractual basis in the relationship between a school on the one hand and a parent or child⁹⁷ on the other. The parent enters into a binding contract with the school to pay for services and perhaps

to the free exercise of religion, however, and absent the religious element it is unlikely that the Court would hold that a parent may disregard a compulsory attendance law. See generally *Pierce v. Society of Sisters*, 268 U.S. 510, 534 (1925).

Of course, other cases exist defining the protection given to one or another aspect of the individual's private life, most notably protection from criminal investigations that invade one's privacy, e.g., *Terry v. Ohio*, 392 U.S. 1 (1968); *Katz v. United States*, 389 U.S. 347 (1967). These cases add to the spirit of the law bearing on the cases under discussion, but are not directly relevant to the problem of the freedom to be uncumbered in intimate relationships and associations.

⁹³ 515 F.2d at 1093 (Russell, Field & Widener, JJ., dissenting).

⁹⁴ *Id.* at 1092-93 (Russell, Field & Widener, JJ., dissenting).

⁹⁵ 392 U.S. 409 (1968). See text accompanying notes 31-33 *supra*.

⁹⁶ 515 F.2d at 1093 (Russell, Field & Widener, JJ., dissenting).

⁹⁷ In the ordinary case, the child does not contract directly with the teacher, but this is essentially because the child makes none of his own contracts in matters of substance. Justice Douglas' dissenting opinion in *Wisconsin v. Yoder*, 406 U.S. 205 (1972), suggests that the child has some right to determine whether and where he wishes to go to school. *Id.* at 244-46 (Douglas, J., dissenting in part). If the child's role as a decisionmaker is accepted, the contract between the young student and the teacher clearly will be established. The corresponding relationship of an adult student to a college, for instance, involves the acceptance of mutual obligations and rights and not merely the subordination of the student to the teacher. In the case of the young student this consensual relationship is not as clear, because of the seeming split of the child's legal personality between himself and his parents.

to perform other duties (such as ensuring the promptness and neat appearance of his child) in return for the provision of education. The period during which a student applies for admission and chooses among schools is clearly a contract formation period. Before the relationship of teacher and pupil ensues, an agreement to teach and to send one's child to learn, in return for a consideration, is required. Providing teachers, curricula, classrooms, and so forth are all undeniably contractual responsibilities of the school. A contractual arrangement thus forms the basis of all our private educational institutions, except perhaps a few foundlings' schools.⁹⁸

As noted above,⁹⁹ the Court of Appeals for the Fifth Circuit found, in *Cook v. Advertiser Co.*,¹⁰⁰ that a standing opportunity to place social notices in a newspaper does not constitute an offer of a unilateral contract, because the Advertiser charged no fee for stories appearing on the society page and persons who submitted information for publication had no rights against the newspaper. Thus, a black who was denied publication of her announcement in the portion of the paper available to whites did not have a cause of action under section 1981. However, a parent who pays to enroll his child in a private school certainly has rights against the educators who operate the institution. The opportunity to obtain these rights is denied to a person who is refused a contract because he is nonwhite. The application of the contract concept to the private school situation is not the manipulation of a formal relationship for the purpose of opening a door to government regulation, but rather is a recognition of a substantial relationship.

B. *Autonomy in the Context of Private Schools*

1. The Decision in *Cook v. Hudson*

The supposed right to participate in discriminatory practices has arisen in a setting different from but related to the attacks on segregated private schools under section 1981. In *Cook v. Hudson*¹⁰¹ three public school teachers asserted a right under

⁹⁸ Marriage represents a completely different case. There is a legal contract of marriage into which the two parties enter, but that is not the foundation of the relationship. The circumstance of marriage would for the most part exist in the absence of any conception of contract and perhaps in the absence of any organized society at all.

⁹⁹ Text accompanying note 43 *supra*.

¹⁰⁰ 458 F.2d 1119 (5th Cir. 1973).

¹⁰¹ 365 F. Supp. 855 (N.D. Miss.), *aff'd*, 511 F.2d 744 (5th Cir. 1973), *petition for cert. filed*, 44 U.S.L.W. 3230 (U.S. Oct. 1, 1975) (No. 75-503).

section 1983¹⁰² to send their children to segregated private schools despite a school board policy denying their right to do so. The Board of Education of Calhoun County, Mississippi, acting pursuant to a desegregation order,¹⁰³ adopted an unwritten policy (not required by the desegregation order but approved by the Justice Department) of not hiring or rehiring teachers, residing in the county, who sent their children to a school other than a county public school.¹⁰⁴ Before the 1968 desegregation order there had never been a private school in the county; after the order only one, the segregated "Calhoun Academy," was established. The district court in *Hudson* found that the Academy had been established "to provide a haven for segregated education."¹⁰⁵ Subsequent to adoption of this policy, the plaintiff teachers in *Hudson* were not rehired, solely because they would not comply with the board rule.¹⁰⁶

The school board adopted its policy to ensure that the faculty would be committed to a desegregated school system and that students would not "perceive rejection . . . from a teacher whose own children attend a nearby racially segregated school."¹⁰⁷ Both the district court and the Court of Appeals for the Fifth Circuit upheld the validity of the policy and the dismissal of the teachers, but on different grounds. The district court held that the board policy was valid as applied because the only private school option was a segregated school.¹⁰⁸ The rule was rationally related to the legitimate state purpose of achieving effective, integrated public education, and therefore did not deny the teachers equal protection.¹⁰⁹ The first amendment associational rights of public employees, the court determined,

¹⁰² 42 U.S.C. § 1983 (1970) provides:

Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress.

¹⁰³ *United States v. Calhoun County Bd. of Educ.*, No. WC 6637 (N.D. Miss., Aug. 9, 1968), cited in 365 F. Supp. at 856.

¹⁰⁴ 511 F.2d at 745. Mississippi provides no tenure for public school teachers. *Id.* n.1.

¹⁰⁵ 365 F. Supp. at 857.

¹⁰⁶ *Id.*

¹⁰⁷ *Id.* at 860, quoted in 511 F.2d at 746.

¹⁰⁸ 365 F. Supp. at 859. The district court specifically left open the question whether such a rule would be valid if the private school in question offered a racially neutral educational advantage not available in the public schools. The court found that the purpose of the board rule was limited to dealing with the situation at hand, *id.* at 859-60, and did not consider the question of overbreadth.

¹⁰⁹ *Id.* at 860.

may sometimes be abridged if there is "clear justification" for doing so, such as the need to vindicate the fourteenth amendment rights of the county's schoolchildren who had been the victims of past segregation.¹¹⁰

The court of appeals affirmed, its order accompanied by a per curiam statement of the case and three separate opinions on the law. In voting to affirm, Judge Coleman cited Supreme Court decisions upholding the right of the federal government to prohibit certain political activities among its employees,¹¹¹ asserting that the government policy in question need only be a good faith effort to maintain an effective school system.¹¹² Judge Roney voted to "affirm the district court's conclusion that the school authorities acted within their discretionary authority" in attempting to lessen the detrimental influence of the existence of the Calhoun Academy on the integrated public school system. He added that the case did "not have broad implications" outside its context of court-ordered desegregation.¹¹³

Perceiving the issue differently, Judge Clark dissented because the board's rule imposed a "substantial burden upon the exercise of a fundamental right" without sufficient justification.¹¹⁴ He objected to the finding that this policy advanced the purpose of eradicating discrimination. In Judge Clark's view the district judge gave too much weight to speculative sociological testimony.¹¹⁵ This weak evidence, Judge Clark concluded, should not override the teachers' otherwise protected rights of association and privacy.

2. Balancing Constitutional Interests in *Cook v. Hudson*

If, as Judge Coleman stated,¹¹⁶ the Hatch Act cases adequately resolve the problems raised in *Cook v. Hudson*, then *Hud-*

¹¹⁰ *Id.* at 859 (citing *Pickering v. Board of Educ.*, 391 U.S. 563, 568, 572-73 (1968) (Board of Education could fire teachers only for speech that would "have impeded the teacher's performance of his daily duties in the classroom or to have interfered with the regular operation of the school generally"); *Ullmann v. United States*, 350 U.S. 422 (1956); *Clark v. Holmes*, 474 F.2d 928, 931 (7th Cir. 1972), *cert. denied*, 411 U.S. 972 (1973) (first amendment rights opposed by state interest in employee discipline)).

¹¹¹ 511 F.2d at 748 (Coleman, J.) (citing *United Pub. Workers v. Mitchell*, 330 U.S. 75 (1947); *United States Civil Serv. Comm'n v. National Ass'n of Letter Carriers*, 413 U.S. 548 (1973) (reaffirming *Mitchell*)). In both cases, the first amendment rights of employees were viewed in the context of the government's power to ensure its efficient, honest administration under the Hatch Act, 5 U.S.C. § 7324 (1970).

¹¹² 511 F.2d at 749 (Coleman, J.).

¹¹³ *Id.* at 750 (Roney, J.).

¹¹⁴ *Id.* at 751 (Clark, J., dissenting).

¹¹⁵ *Id.* at 752-53, 756-57 (Clark, J., dissenting).

¹¹⁶ *Id.* at 748 (Coleman, J.).

son has little relevance to the issues raised in *McCrory* and *Riley*. The guiding principle of the Hatch Act decisions is the theory that the state may have an overriding interest in regulating the speech and associations of those who voluntarily enter into public employment. That principle sheds little light on the rights of parents and teachers in the private school context. The Hatch Act cases do not, however, completely dispose of the question presented in *Hudson*. Instead, the *Hudson* decision should be viewed as depending on a balancing of the relevant first and fourteenth amendment interests, and thus is illuminating in considering *McCrory* and *Riley*.

There are significant factual distinctions between the United States Civil Service and a local school system and between regulating certain types of partisan political speech and electioneering and regulating association related to the right to bring up one's children as one sees fit.¹¹⁷ There are also distinctions between the nature of the government interests protected by the Hatch Act and those of the school board in *Hudson*. These distinctions suggest that although the general balancing approach should not be abandoned, there is insufficient basis for the suggestion by Judge Coleman in *Hudson* that associational and privacy interests in segregated private schools are easily overridden.

In the Hatch Act, Congress exercised its power to protect the integrity of the federal government from a widely perceived threat of corruption. This is a general governmental power; one can hardly conceive of a government that does not possess it to some degree. Yet it is a special power in the sense that its exercise is fundamental to the survival of government, though it does not advance any particular aim of government. The peculiar nature of this power precludes unexamined reliance on the Hatch Act cases to solve the problems raised by encroachment on civil liberties in the advancement of less basic governmental interests.

Were the local government's power to run an effective school system the only issue in *Hudson*, dissenting Judge Clark would have a powerful argument that the school board's policy should be invalidated. The important rights of association and familial privacy should not be infringed by a general govern-

¹¹⁷ The parent is responsible for the child's education even though the state has established schools and could conceivably have assumed responsibility. See *Pierce v. Society of Sisters*, 268 U.S. 510, 535 (1925): "[T]hose who nurture [the child] and direct his destiny have the right, coupled with the high duty, to recognize and prepare him for additional obligations."

mental interest in operating schools, especially where, as here, the evidence indicates only indirectly that the policy infringing those rights advances the government's claimed interest.¹¹⁸

There is, however, a stronger characterization of the county's case. The nature of the power exercised by the school board is not significantly less important than the federal power underlying the Hatch Act. Besides having an interest in running its schools well, the school board in *Hudson* was acting to implement a court order requiring it to enforce the fourteenth amendment rights of the county's black schoolchildren. This special concern for effectively establishing the priority of equal protection in the public school system elevates the justification for the board's exercise of power to a level comparable to that underlying the Hatch Act decisions. Chief Judge Keady recognized the importance of the school district's equal protection concerns in the trial court opinion: "Conceding there must be clear justification for curtailing or limiting First Amendment rights, nevertheless, plaintiffs' rights as parents may not be considered in isolation, and to the exclusion of other constitutional demands of equal, if not greater, magnitude."¹¹⁹

The existence of this fourteenth amendment equal protection interest of the county schoolchildren as a basis for the board's policy places the teachers' associational and familial rights in conflict with strong forces indeed.¹²⁰ If the board's policy had been invalidated in *Hudson*, the fourteenth amendment rights of those protected by the 1968 integration order might have been infringed.¹²¹

A conflict between constitutional rights such as the one that occurred in *Hudson* is rare but by no means unique. Justice Douglas attempted to avoid a similar conflict in his famous dissent in *Moose Lodge No. 107 v. Irvis*.¹²² By separating the issue of

¹¹⁸ 511 F.2d at 752-53 (Clark, J., dissenting).

¹¹⁹ 365 F. Supp. at 859. The opinion continued (quoting *Ullman v. United States*, 350 U.S. 422, 428 (1956)):"As no constitutional guaranty enjoys preference, so none should suffer subordination or deletion."

¹²⁰ The 1968 desegregation order issued pursuant to the fourteenth amendment is of course in accord with the spirit of the thirteenth amendment as well.

¹²¹ Of course, this does not vitiate Judge Clark's argument concerning the tenuousness of the psychological evidence supporting the board's policy. But psychological and sociological evidence has been important in showing harm under the fourteenth amendment. See *Brown v. Board of Educ.*, 347 U.S. 483 (1954). Where the issue is whether the fourteenth amendment interests of a large number of schoolchildren will be served by a given policy, psychological evidence may be the only kind adducible.

¹²² 407 U.S. 163, 179-84 (1972) (Douglas, J., dissenting). Justice Douglas followed the dictum in his opinion for the Court in *Evans v. Newton*, 382 U.S. 296, 299 (1966): "A

association from that of state action, he could affirm the right of individuals to associate with complete freedom but deny the right of discriminatory associations to receive significant government benefits available in limited supply. A majority of the Supreme Court considered this approach in *Gilmore v. City of Montgomery*,¹²³ in which segregated school groups were enjoined from the *exclusive* use of recreational facilities in city parks in order to guarantee full implementation of public park desegregation orders. The private segregated organizations were not enjoined from using the park, however, although the Court acknowledged that upon a finding of "impairment of an outstanding school desegregation order" such a result might be warranted on remand.

The Court was aware of the implications of its position even though no private group was ordered to integrate:

It should be obvious that the exclusion of any person or group . . . from public facilities infringes upon the freedom of the individual to associate as he chooses. . . . [H]owever, we must also be aware that the very exercise of that freedom to associate by some may serve to infringe that freedom for others. Invidious discrimination takes its own toll on the freedom to associate, and it is not subject to affirmative constitutional protection when it involves state action.¹²⁴

The Court recognized that associational rights may conflict both

rights,¹²⁵ while the dissenters in that case characterized them only as associational.¹²⁶ The *Hudson* dissent spoke of the "personal freedom as parents to choose the academic environment in which their children will be educated," a freedom that may be "viewed as a part of a citizen's Fourteenth Amendment liberty or First Amendment freedom of association or a combination of both."¹²⁷

This disparity of definition arises not from the intrinsic complexity of the interest claimed by the schoolteacher parents (one has an intuitive feel for what it is); but rather from the fact that the Supreme Court has never clearly formulated a doctrine of associational rights. Only in *Pierce v. Society of Sisters*¹²⁸ did the Supreme Court consider doctrines of association and privacy in a context analogous to the one under consideration here. In *Pierce* the Court found these rights guaranteed by the fourteenth amendment.¹²⁹ It must be noted, however, that *Pierce* was decided during the peak of the "substantive due process" era, when state interests were frequently afforded little weight.

Parents' decisions concerning the education of their children involve both political and social aspects of first amendment interests. Parents' decisions concerning the education of their offspring are political within the broad meaning of "politics" adopted by the Supreme Court in *NAACP v. Button*.¹³⁰ Certainly, discussion of educational matters is protected as discussion of a subject of public interest.¹³¹ Many parents send their children to school not only because of compulsory attendance laws, but also with the hope that education will enable their children to make a "distinctive contribution"¹³² to society. Without doubt those who operate schools also hope this will be one result of their efforts. The decision to enroll one's child in a private school "presenting ideas or having educational methods or practices which are not available in the public schools"¹³³ may be viewed as a political choice, as may the decision to establish such a school. Operating

¹²⁵ 515 F.2d at 1087.

¹²⁶ 515 F.2d at 1094-96 (Russell, Field & Widener, JJ., dissenting).

¹²⁷ 511 F.2d at 750 (Clark, J., dissenting).

¹²⁸ 268 U.S. 510 (1925).

¹²⁹ 268 U.S. at 534-35. The *Pierce* Court found the rights in the general principle of "liberty" and did not identify or place them more specifically. See note 164 *infra* & accompanying text.

¹³⁰ 371 U.S. 415 (1963).

¹³¹ *Pickering v. Board of Educ.*, 391 U.S. 563, 573 (1968).

¹³² *NAACP v. Button*, 371 U.S. 415, 431 (1963).

¹³³ *McCrary v. Runyon*, 515 F.2d 1082, 1087 (4th Cir. 1975) (en banc), cert. granted, 96 S.Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306).

private schools, at least when they do not transgress state statutes and regulations reasonable under *Pierce*,¹³⁴ legitimately presents the public with a choice of educational alternatives. The individual should be as free to choose among these alternatives as he is to choose among the proposed policies of candidates for election to school boards.

The associational right claimed by the parents is also social. A parent may choose a private school for his child partly on the basis of the sort of people with whom the parent wishes the child to associate. A parent may believe that a child's social environment is important to character development. Until *Riley* and *McCrory*, no case had suggested that in the absence of state action the power of the state to regulate education included the power to prescribe who must be allowed to attend a particular private school. *Pierce* limits the social setting that one may seek out in a private school only to the extent of permitting the state to require that teachers be of good moral character.¹³⁵

The right of social association is part and parcel of the assertedly political right discussed above. But in addition, given the absence of support for the position that the regulatory power of the state permits it to prescribe which students must be admitted to which private schools, the school's choice of the composition of its student body is a legitimate choice of educational methods. If the school has the right to present such policies to the public, then the public has a correlative right to consider those policies in choosing a school.

In addition to these associational rights, plaintiffs' rights of familial privacy, akin to those raised in *Griswold*,¹³⁶ *Roe v. Wade*,¹³⁷ *Stanley v. Georgia*,¹³⁸ and *Eisenstadt*,¹³⁹ are involved in *Hudson*. Although these cases all center on the problem of sexuality, their logic need not end there. Indeed, *Griswold* builds the right of sexual freedom in part on the freedom to choose a

¹³⁴ The *Pierce* Court did not question

the power of the State reasonably to regulate all schools, to inspect, supervise and examine them, their teachers and pupils; to require that all children of proper age attend some school, that teachers shall be of good moral character and patriotic disposition, that certain studies plainly essential to good citizenship must be taught, and that nothing be taught which is manifestly inimical to the public welfare.

268 U.S. at 534.

¹³⁵ *Id.*

¹³⁶ *Griswold v. Connecticut*, 381 U.S. 479 (1965).

¹³⁷ 410 U.S. 43 (1973).

¹³⁸ 394 U.S. 557 (1969).

¹³⁹ *Eisenstadt v. Baird*, 405 U.S. 438 (1972).

school in *Pierce*.¹⁴⁰ Sex is but one of a number of concerns of such central importance to the familial relationship that it should be unregulated by government.¹⁴¹ The choice of educational policy is fundamental to the relationship between parent and child and to the parent's responsibility for the child. It is an intensely personal matter which in very large part should be between parent and child, and eventually between them and the school.

In summary, the right asserted by the plaintiffs in *Hudson* to send their children to a school of their choice consists of at least (1) an interest in familial privacy, including the freedom to bring up a child as one chooses, (2) an interest in the social association of both themselves and their children, and (3) quasi-political interests in effectively supporting a favored educational philosophy. When these rights are viewed together, the real issue is the "autonomy"¹⁴² of the parent. Professor Henkin has written:

Primarily and principally the new Right of Privacy is a zone of prima facie autonomy, of presumptive immunity from regulation, in addition to that established by the first amendment. The zone, Justice Blackmun told us, . . . consists of 'personal rights' that can be deemed 'fundamental,' that are 'implicit in the concept of ordered liberty.' The right has 'some extension' to marriage, . . . family relations and parental autonomy. But we will know which rights are and which are not within the zone only case by case¹⁴³

Professor Henkin's formulation of autonomy focuses primarily on the four "sexual privacy" cases,¹⁴⁴ yet his analysis applies equally well to a much larger set of rights including those examined above.¹⁴⁵ The courts have denominated as "associational" the rights upheld in *NAACP v. Alabama ex rel.*

¹⁴⁰ 381 U.S. at 482-83.

¹⁴¹ On the other hand, not even the sexual relations of the family are wholly immune from state regulation. Prohibitions of incest, for example, still stand. See, e.g., Miss. CODE ANN. § 93-1-1 (1972).

¹⁴² This name for the collection of constitutional rights was suggested in Henkin, *supra* note 79, and *On Privacy*, *supra* note 79, as a useful device for analyzing the real nature of the rights involved in *Griswold*, *Eisenstadt*, *Stanley v. Georgia*, and *Roe v. Wade*. Henkin notes that these "familial" rights are less matters of "privacy" in the traditional sense of keeping one's affairs secret, than of "autonomy," meaning the ability to act free of governmental interference.

¹⁴³ Henkin, *supra* note 79, at 1425-26.

¹⁴⁴ Cases cited notes 136-39 *supra* & accompanying text.

¹⁴⁵ Text accompanying notes 49-92 *supra*.

Patterson,¹⁴⁶ *NAACP v. Button*,¹⁴⁷ and *Shelton v. Tucker*,¹⁴⁸ but they can easily be seen as rights of autonomy in Professor Henkin's sense. The rights asserted by the NAACP on behalf of its members in *Alabama ex rel. Patterson* and the rights asserted in *Shelton* are rights of privacy in the traditional sense of the right to keep information about oneself secret from the government. In both cases, however, the key support for the holding was the conclusion that governmental knowledge of the association in question impaired the individual's autonomy by subjecting him to the possibility of governmental or other intimidation.¹⁴⁹ Similarly, the limitation of autonomy in childbearing was the central issue in *Roe v. Wade*.¹⁵⁰ Further, while *Button* involved the ability of the NAACP as an organization to catalyze litigation, the basis of the holding was that the members of the organization had a right to be free from government interference when advancing their beliefs in this manner.

As Professor Henkin states, the zone in question is only one of "prima facie autonomy, of presumptive immunity from regulation";¹⁵¹ this holds true for the expanded zone of autonomy suggested here as well. The state's interest in the mother's decision to abort grows with the fetus.¹⁵² Similarly, *Gilmore v. City of Montgomery* concerned the point at which restrictions can be imposed on the autonomy of individuals to practice segregation in private groups.¹⁵³ In *Pierce* the parents were presumed to have autonomy in the decision where to send their children to school, subject to reasonable regulation of certain aspects of education. In *Shelton v. Tucker* the Court did not foreclose the possibility of inquiry into specific memberships of teachers.¹⁵⁴

The theoretical objection to this consolidation of concepts is that the concepts do not necessarily share a common basis. The Supreme Court in *Griswold* found the right of marital privacy (or autonomy) in the "peripheral rights" that emanate from the first amendment.¹⁵⁵ The reasoning in *Alabama ex rel. Patterson* was

¹⁴⁶ 357 U.S. 449 (1958).

¹⁴⁷ 371 U.S. 415 (1963).

¹⁴⁸ 364 U.S. 479 (1960).

¹⁴⁹ *Shelton v. Tucker*, 364 U.S. 479, 486-87 (1960); *NAACP v. Alabama ex rel. Patterson*, 357 U.S. 449, 462 (1958).

¹⁵⁰ 410 U.S. 43 (1973).

¹⁵¹ Henkin, *supra* note 79, at 1425.

¹⁵² *Roe v. Wade*, 410 U.S. 113, 162-65 (1973).

¹⁵³ 417 U.S. 556, 575 (1974).

¹⁵⁴ 364 U.S. at 487-88.

¹⁵⁵ 381 U.S. at 482-84.

similar.¹⁵⁶ However, the Court in *Griswold* noted that the right there discovered was not an exclusive first amendment right but was also supported by the third, fourth, fifth, and ninth amendments.¹⁵⁷ The right in *Roe v. Wade* is less securely tied to the first amendment; Justice Blackmun stated¹⁵⁸ that different cases tie different parts of the right to different constitutional provisions, the first,¹⁵⁹ fourth, fifth,¹⁶⁰ ninth,¹⁶¹ and fourteenth¹⁶² amendments, along with the general concept of penumbral rights.¹⁶³ *Pierce* itself fails to tie the right it assures to any concept more definite than that of general liberty.¹⁶⁴ It is questionable whether rights of such diverse constitutional origin are properly subsumed under the single rubric of autonomy.

Most of the majority opinions ground the rights discovered in the cases under discussion at least partly in the first amendment.¹⁶⁵ Some, particularly *Griswold* and *Roe v. Wade*, draw much more widely from the Constitution. The *Meyer v. Nebraska-Pierce v. Society of Sisters* line of cases does not even find partial basis in the first amendment, and these cases present facts

¹⁵⁶ 357 U.S. at 460-62.

¹⁵⁷ 381 U.S. at 481-85.

¹⁵⁸ 410 U.S. at 152.

¹⁵⁹ *Id.* (citing *Stanley v. Georgia*, 394 U.S. 557, 564 (1969)).

¹⁶⁰ *Id.* (citing, *inter alia*, *Terry v. Ohio*, 392 U.S. 1, 8-9 (1968); *Katz v. United States*, 389 U.S. 347, 350 (1967)).

¹⁶¹ *Id.* (citing *Griswold v. Connecticut*, 381 U.S. 479, 486 (1965) (Goldberg, J., concurring)).

¹⁶² *Id.* (citing *Meyer v. Nebraska*, 262 U.S. 390, 399 (1923)).

¹⁶³ *Id.* (citing *Griswold v. Connecticut*, 381 U.S. 479, 484-85 (1965)).

¹⁶⁴ The *Pierce* philosophy is best set out in a passage from *Meyer v. Nebraska*, 262 U.S. 390, 399 (1923):

While this Court has not attempted to define with exactness the liberty thus guaranteed [by the fourteenth amendment], the term has received much consideration and some of the included things have been definitely stated. Without doubt, it denotes not merely freedom from bodily restraint but also the right of the individual to contract, to engage in any of the common occupations of life, to acquire useful knowledge, to marry, establish a home and bring up children, to worship God according to the dictates of his own conscience, and generally to enjoy those privileges long recognized at common law as essential to the orderly pursuit of happiness by free men.

Among recent jurists, at least the second Justice Harlan would not have objected to this approach, believing as he did that the proposition that all constitutionally protected rights must be tied, however tenuously, to some provision more specific than this guarantee, might permit certain rights "implicit in the concept of ordered liberty" to be excluded from fourteenth amendment protection. See *Griswold v. Connecticut*, 381 U.S. 479, 499 (1965) (Harlan, J., concurring).

¹⁶⁵ The exception of the fourth and fifth amendment cases is not important for purposes of this Comment. See, e.g., cases cited note 92 *supra*. These mostly criminal cases generally guarantee the traditional sense of privacy, meaning the right to be free from others' prying into one's affairs.

most closely analogous to our current concerns. The opinions speak generally of the fourteenth amendment guarantee of liberty.¹⁶⁶ They were written during the heyday of economic substantive due process in the 1920's, however, and their rationales probably did not survive the demise of that doctrine. Indeed, *Meyer* stresses the teacher's right to pursue a vocation,¹⁶⁷ and *Pierce* emphasizes the property and business interests of the school.¹⁶⁸ The general reliance on the liberty guaranteed the parents by the fourteenth amendment in *Pierce* is a close analogue to this reasoning. Yet no one suggests that the results of *Meyer* and *Pierce* are no longer law; the *Griswold* Court cited both with approval.¹⁶⁹ *Meyer* and *Pierce* are of course completely compatible with the new cases proclaiming associational and privacy rights. They have been absorbed into the new jurisprudence of the Bill of Rights, and one suspects if they were to be decided today, their language would closely resemble that of the privacy and association cases. The rights identified in all these cases remain at least presumptively with the people because of the ninth amendment.¹⁷⁰

Another objection to this formulation of the right of autonomy is that the sort of individual interests involved in sexual relations and political association, for example, are too diverse to be protected by a single right. Yet in each case the issue is the same: whether in the context of one's sexual intimacies, political associations, or other activities there is a right, arising from the first amendment and other provisions of the Bill of Rights, to act autonomously, that is, without government interference.¹⁷¹ That we have different reasons for wishing our actions to be free of governmental regulation in different contexts no more proves that the autonomy sought consists of several parts than that our having different interests in speaking freely and on different subjects proves that there is more than one right of free speech;

¹⁶⁶ See note 164 *supra*.

¹⁶⁷ 262 U.S. at 400.

¹⁶⁸ 268 U.S. at 534-35.

¹⁶⁹ 381 U.S. at 481, 482; also cited with approval in *Eisenstadt v. Baird*, 405 U.S. 438, 457 (1972) (Douglas, J., concurring).

¹⁷⁰ See *Griswold v. Connecticut*, 381 U.S. 479, 486 (1965) (Goldberg, J., concurring).

¹⁷¹ The question whether this is a resurrection of substantive due process cannot be fully explored here. It is not a revival of *economic* substantive due process, whose abuse led to the decline of the doctrine. Note also that the interests of individuals in acting autonomously in the situations under consideration have been tied to guarantees in the Bill of Rights more specific than general liberty, or at least has been found in the penumbras of such guarantees.

the right to discuss politics and the right to discuss personal matters are the same. The difference between the cases is that there are different government interests pitted against the right of autonomy. Thus the balances struck may be different in each case. A theoretical basis for the right of autonomy, unified in its central features if not in all details, has thus been laid.

4. Reconciliation of Constitutional Interests

The perennial problem of constitutional litigation is determining when an individual constitutional interest is outweighed by a conflicting state interest. Many court opinions and much commentary have sought to determine when the state interest must be "compelling" and the means used to achieve it "necessary," when the interest must be "substantial," and when it need merely be "legitimate" and the means to achieve it "rational." Such a determination is arduous, and, as is evidenced by the splits of opinion on the Supreme Court, an unscientific undertaking.¹⁷²

Fortunately, the facts of *Hudson* allow us to short-circuit most of the inquiry because of the nature of the state's interest. The most significant state interest involved here is the protection of the right to equal protection of each of the black schoolchildren of Calhoun County. The countervailing right of autonomy is accurately characterized as presumptive or *prima facie*; it contains a built-in acknowledgement of limitation. The right of black people to equal protection of the law has never been found less important than any other interest;¹⁷³ the balance struck in *Hudson* does not depart from precedent.

C. *Autonomy and Thirteenth Amendment Rights in the McCrary Situation*

The kind of constitutional balancing required for analysis of

¹⁷² See generally, e.g., *San Antonio School Dist. v. Rodriguez*, 411 U.S. 1 (1973) (majority opinion and opinion of Marshall, J., dissenting); *Dandridge v. Williams*, 397 U.S. 471 (1970) (majority opinion and opinion of Marshall, J., dissenting); *Harper v. Virginia Bd. of Elections*, 383 U.S. 663 (1966); *Railway Express Agency, Inc. v. New York*, 336 U.S. 106 (1949); *Korematsu v. United States*, 323 U.S. 214 (1944).

¹⁷³ In only one modern case has state discrimination based on race been found supportable, and that case arose in a tense wartime atmosphere. See *Korematsu v. United States*, 323 U.S. 214 (1944). The refusal of the Supreme Court in *Gilmore v. City of Montgomery*, 417 U.S. 556 (1974), to grant injunctions against the nonexclusive use of public recreation facilities by discriminatory groups was not a denial of the paramount nature of fourteenth amendment rights, but an admission by the Court that it lacked sufficient information to decide whether such use sufficiently implicated the city in the discriminatory practices of the groups to constitute state action.

*Hudson*¹⁷⁴ can be applied to *McCrary*¹⁷⁵ and *Riley*¹⁷⁶ as well. The constitutional conflict in these two cases is even sharper than in *Hudson* or *Gilmore*.¹⁷⁷ In the former cases two private parties asserted conflicting individual rights, whereas in the latter cases local governments asserted the rights of others. The method used above to short-circuit the inquiry into degrees of constitutional interest and necessity of particular means will be even more useful here. The conflicting rights have closely analogous constitutional bases, thus intensifying the value judgment required to dispose of these cases.

The claim of the plaintiffs in *McCrary* and *Riley* is that a statute, section 1981 of title 42 of the United States Code, protects nonwhites from racial discrimination in contract formation by private parties. The constitutional provision granting Congress power to afford them this protection is the thirteenth amendment, which explicitly forbids slavery but has been held to allow Congress also to prohibit any practice that it rationally determines imposes badges or incidents of slavery, particularly on black persons.¹⁷⁸ The power exercised by Congress here is very specific: It is the power to enact appropriate legislation to prevent whites from imposing badges of slavery on nonwhites by refusing to contract with them. The right claimed by plaintiffs, although statutory, carries the imprimatur of the thirteenth amendment; without that amendment the right would probably be beyond the power of Congress to guarantee, at least to the extent that it applies to purely private discrimination.¹⁷⁹ Congress enforces the thirteenth amendment right to live as a free individual under the jurisdiction of the United States by enforcing a right to make private contracts not directly protected by the Constitution; one personal right gives effect to another.

This relationship of rights and power is different from that

¹⁷⁴ *Cook v. Hudson*, 511 F.2d 744 (5th Cir. 1973), *petition for cert. filed*, 44 U.S.L.W. 3230 (U.S. Oct. 1, 1975) (No. 75-503).

¹⁷⁵ *McCrary v. Runyon*, 515 F.2d 1082 (4th Cir. 1975) (en banc), *cert. granted*, 96 S. Ct. 354 (1975) (Nos. 75-62, 75-66, 75-278, 75-306).

¹⁷⁶ *Riley v. Adirondack Southern School for Girls*, 368 F. Supp. 392 (M.D. Fla. 1973), *appeal docketed*, No. 74-1976, 5th Cir., Apr. 15, 1974.

¹⁷⁷ *Gilmore v. City of Montgomery*, 417 U.S. 556 (1974).

¹⁷⁸ *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 440-43 & n.78 (1968) (overruling prior constitutional construction of § 1981 and upholding § 1982 as a rational measure aimed at eliminating badges and incidents of slavery). *See Johnson v. Railway Express Agency, Inc.*, 95 S. Ct. 1716, 1720 (1975); *Tillman v. Wheaton-Haven Recreation Ass'n*, 410 U.S. 431, 439-40 (1973).

¹⁷⁹ It has not been claimed that § 1981 could be enacted under the commerce power, because the statute is not limited to contracts affecting commerce.

usually involved in the enactment of a law. For example, when Congress enacts a statute pursuant to the commerce power, it may create in certain individuals statutory rights.¹⁸⁰ But those rights are based on the grant of a general governmental power to Congress, not the grant of a power to enforce a specific constitutional right; the grant of the commerce power to Congress does not create in individuals a right to a well-regulated economy, and statutory rights granted to individuals thereunder are not found on individual constitutional rights.¹⁸¹ The contrast between the two types of powers does not suggest that absent congressional action, there would be an independent right in individuals to the protection now afforded by section 1981. The Supreme Court has held that the congressional power rationally to determine the badges and incidents of slavery is part of congressional power to enforce the thirteenth amendment.¹⁸² Congress would not need this power if the thirteenth amendment granted a self-executing right to be free of such badges. This analysis of the right asserted by the *McCrary* and *Riley* plaintiffs does not depend on whether the statute is interpreted in a "limited" or "unlimited" fashion¹⁸³ as long as either reading gives effect to a power of Congress rationally exercised. Once the courts have satisfied themselves as to the meaning and rationality of the statute, the right guaranteed is confirmed as a protection appropriate to the enforcement of the freedom guaranteed by the thirteenth amendment.

The opposing right claimed by the *McCrary* and *Riley* defendants is the right of autonomy discussed above in the context of *Cook v. Hudson*.¹⁸⁴ The right has two aspects: first, there is the right of parents to send their children to the type of school that they see fit, which defendants assert on the parents' behalf; second, there is the right of defendants themselves to operate a school according to their best judgment. The first aspect is the same as the right asserted by plaintiffs in *Hudson*; the second

¹⁸⁰ E.g., the National Labor Relations Act, 29 U.S.C. § 151 *et seq.* (1970), granting workers rights to engage in certain concerted activities without fear of employer retaliation.

¹⁸¹ For example, workers have no superstatutory (constitutional) right to be free from economic pressure from employers; the NLRA alone creates that right, *see* note 180 *supra*.

¹⁸² *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 440-41 (1968).

¹⁸³ *See* text accompanying notes 187, 200-08 *infra*.

¹⁸⁴ Since the demise of economic substantive due process, the defendants cannot claim that § 1981 interferes unreasonably with their business interest in running a school as they wish.

recalls the rejected economic substantive due process theories of *Pierce* and the early economic regulation cases. Education, however, is more than just a business. All education involves teaching debatable ideas and values as well as facts; this is never truer than in private general elementary and secondary education offered and selected as an alternative to public school methods or ideas.

Thus, segregated education may involve association for the purpose of propagating a social, political, and moral philosophy, the type of association protected in *NAACP v. Button*.¹⁸⁵

The rights of both plaintiffs and defendants in these cases belong to those sets of rights necessary to the enforcement of the rights explicitly granted individuals by the Constitution. Although the rights claimed by plaintiffs were created by Congress while those asserted by defendants were "discovered" by the courts, the relationship of each right to the Constitution is the same: Each buttresses the enforcement of explicit rights.

Because of this similarity, the analysis of each right in terms of "compelling interest," "fundamentality," and so forth need not be carried out in detail;¹⁸⁶ the relative constitutional weight of the rights cannot be determined. Which right is more important must be determined not in the abstract, but in the particular factual situation, in terms of both policy and ethics.

The "unlimited" reading of section 1981 asserts that any act of racial discrimination in the formation or performance of contracts constitutes an insult to the individual against whom the discrimination is directed,¹⁸⁷ sufficient to constitute a badge of slavery. Acts of insult differ in the amount of harm done, which determines the amount of damages awarded or the type of injunction granted. In all cases, however, the type of injury is considered the same, so that all plaintiffs have the same degree of interest in vindicating constitutional rights. This formulation answers the *McCrory* dissenters' contention that certain denials of contracts are more important than others, and that only impor-

¹⁸⁵ 371 U.S. 415 (1963); see *NAACP v. Alabama ex rel. Patterson*, 357 U.S. 449 (1958).

Moreover, the fact that neither the majority nor dissenting opinion in *McCrory* distinguishes between the rights of the defendant educators and those of the parents of the children they teach indicates that these rights are fundamentally the same. The rights of the two groups, if not identical are at least complementary. *But cf.* *Wisconsin v. Yoder*, 406 U.S. 205, 241-46 (1972) (Douglas, J., dissenting in part).

¹⁸⁶ See text accompanying note 172 *supra*.

¹⁸⁷ Note that the damages awarded in *McCrory* were for humiliation, embarrassment, and mental anguish. 515 F.2d at 1089.

tant denials are forbidden by section 1981; the right to contract to send one's child to a private school is not protected, because an adequate integrated public school system is available. Under the "unlimited" reading of section 1981, discrimination is forbidden not because it may prevent a black person from attaining one of his goals, but because it brands the victim with the odium of slavery. If acts of discrimination that cause the smallest actual injury are to be regarded as equivalent to those causing the largest, then the fact of the insult itself must be extremely powerful; an interest of the discriminator in exercising any other constitutional right will need to be extremely strong in order to overcome it.

In *McCrary* the level of defendants' interest in autonomous action is high. A restriction of autonomy in choosing a school for one's children limits the parents' ability to associate for purposes that are more than colorably political, to associate for social purposes, and to make decisions concerning intimate familial matters, any one of which enjoys constitutional protection.

The interests of plaintiffs and defendants not only have equally weighty constitutional bases, but they bear comparable rank among the rights that could logically be supported by those bases. The conflict can be resolved only by considering the consequences of affirming or reversing *McCrary*. A reversal would undoubtedly be formulated to allow the section 1981 and 1982 cases decided to date to remain standing.¹⁸⁸ Under the new formulation, certain types of racial discrimination practiced by private parties, though as invidious as any other discrimination, could not be reached by Congress because of the shield of autonomy that protects the discriminators. Protection would extend not only to discrimination involving essentially private interests, such as whom one will marry or with whom one will form a drinking club,¹⁸⁹ but also to discrimination in which the interests are more public, such as what type of education will be available to the children of a community.¹⁹⁰ These consequences follow if infringement of defendant's autonomy rights cannot be justified by the need to serve the thirteenth amendment interests

¹⁸⁸ E.g., *Johnson v. Railway Express Agency, Inc.*, 95 S. Ct. 1716 (1975); *Tillman v. Wheaton-Haven Recreation Ass'n*, 410 U.S. 431 (1973); *Sullivan v. Little Hunting Park, Inc.*, 396 U.S. 229 (1969); *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409 (1968).

¹⁸⁹ Cf. *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163 (1972).

¹⁹⁰ Cf. *Gilmore v. City of Montgomery*, 417 U.S. 556, 575 (1974), in which the Court expressed the concern that complete enforcement of one's right of association may derogate someone else's.

protected by section 1981. A decision upholding the rights of defendants in *McCrary* would in no way reflect a return to the doctrine of *Plessy v. Ferguson*,¹⁹¹ but only the position that there are certain types of discrimination, linked to personal preferences, that the body politic cannot and should not attempt to eliminate.

Should the *McCrary* holding be affirmed, the Supreme Court will be extending the constitutional commitment to end racial discrimination as a relic of slavery. The question is whether this extension would carry with it a license to invade other constitutional liberties too deeply. The dissenters in *McCrary*¹⁹² and *Hudson*¹⁹³ feared that associational values would be infringed too easily and often in the future, for reasons that are not compelling. The *McCrary* dissenters, as noted above, feared that this decision would lead to an abuse of the concept of contract as a door opener to governmental regulation and coercion of unwilling co-contractors.¹⁹⁴

These fears are justified, if at all, only in regard to the power of Congress and the courts to eliminate racial segregation and other badges of slavery.¹⁹⁵ The logic of *McCrary* would not lead to a wholesale expansion of the government's ability to invade private lives. Although the *McCrary* holding could be used to justify infringing certain personal rights in a substantial manner solely to vindicate another's personal right, no court will hold, for example, that a disappointed nonwhite suitor has an action under section 1981 against a white for refusal to marry. The interests are too intensely personal and, although narrower, far stronger than even the parents' interests in *McCrary* and *Hudson*.

¹⁹¹ 163 U.S. 537 (1896).

¹⁹² 515 F.2d at 1093-96 (Russell, Field & Widener, JJ., dissenting).

¹⁹³ 511 F.2d at 755-57 (Clark, J., dissenting).

¹⁹⁴ 515 F.2d at 1093 (Russell, Field & Widener, JJ., dissenting).

¹⁹⁵ The post-Civil War amendments are peculiar constitutional provisions. They were intended to protect the rights of a particular class of citizen. The thirteenth amendment is the only constitutional provision that, in terms, guarantees individual rights against infringement by other individuals. Originally, the rights created by Congress pursuant to this amendment were meant to protect blacks from a return to slavery after the Civil War, see *Civil Rights Cases*, 109 U.S. 3 (1883); since then the amendment has been used to attack various systems of involuntary labor, e.g., *Selective Draft Law Cases*, 245 U.S. 366, 390 (1918); *Clyatt v. United States*, 197 U.S. 207 (1905). No serious attempt has been made, however, to suggest that the power to eliminate badges and incidents of slavery extends beyond the power to eliminate all traces of racial discrimination or discrimination against some other class in danger of falling into slavery. The holding in *McCrary* would permit only invasions of autonomy that can effect an end to racial discrimination. There is no license to invade freedoms for any other purpose.

Less extreme cases can be imagined, however, to which the logic of *McCrory* might but should not automatically apply. Prototypical is the case of the private club. If the interests of parents and educators may be overridden in the name of racial integration, why should private clubs with mere social interests be allowed to discriminate when their relationships are contractual in nature? The only response is that there may not be sufficient reason or societal interest in prohibiting such clubs from discriminating. A more extreme example would arise if Congress prohibited racial discrimination by political parties, because political powerlessness is undeniably an accoutrement of slavery, in cases in which the fourteenth amendment would not restrict the party members' freedom of association.¹⁹⁶ Here the public interest in and impact of the activity is greater, but the first amendment protection is also greater because explicit.¹⁹⁷ The Supreme Court should acknowledge that a separate balancing of interests must be essayed in each case. Without such a caveat, courts may find it too easy to sacrifice rights of personal autonomy on the altar of ending racial discrimination.

The reasoning of *McCrory*, even if carried to its extreme, does not license destruction of any and every right to act autonomously in the name of equality. Nor does it imply that unwilling co-contractors can constitutionally be coerced into accord for any and every reason. It does not even permit any and every constitutional right to be invaded in order to eliminate badges of slavery. The holding of *McCrory* does not even imply that Congress may invade all protected areas of life in order to destroy the badges of slavery. The majority admits that section 1981 cannot prevent the teaching of any doctrine.¹⁹⁸ The ability of Congress to determine and destroy badges and incidents of slavery does not extend to a direct denial of a right explicitly stated in the Constitution. A church whose dogma included racial separatism could not be required to accept black members in order to eliminate a badge of slavery.

Thus the holding of *McCrory* allows Congress and the courts to declare: Race is not an absolutely protected basis of association, and certain interests in freedom of action must give way

¹⁹⁶ See *Terry v. Adams*, 345 U.S. 461 (1953).

¹⁹⁷ Cf. *O'Brien v. Brown*, 409 U.S. 1 (1972) (but note that this was "not a case in which claims are made that injury arises from invidious discrimination based on race in a primary contest within a single State," as was *Terry v. Adams*, *id.* at 4 n.1); *National Socialist White People's Party v. Ringers*, 473 F.2d 1010 (4th Cir. 1973).

¹⁹⁸ 515 F.2d at 1087.

before an interest in eliminating racial inequality. The thirteenth amendment does not permit congressional interference with any other constitutional right for any other reason. There is no analogous constitutional provision under which Congress will be able to use the reasoning of *McCrary* in order to invade protected rights.¹⁹⁹ If carefully explained and expressly restricted, the reasoning of the majority in *McCrary* threatens to infringe only a limited set of personal liberties in a limited number of situations. Under the present state of the law, in view of the vital nature of the struggle against the relics of slavery, the delicate balance tips in favor of affirmance.

D. *A Suggested Principle of Limitation for Section 1981
and Its Application to McCrary and Riley*

Although this Comment has suggested that an affirmance of *McCrary v. Runyon* would not necessarily injure essential American liberties, such injuries could conceivably result from a broad construction of *McCrary* and section 1981. An alternative solution, rather than simple affirmance or reversal, might better protect all the interests at stake. For this reason, a construction of section 1981 will be suggested that allows it to operate in most cases in which its effect would be most useful but limits its potential for abuse.

The conventional analysis of section 1981 rests on the determination that any racial discrimination in the formation or performance of a contract humiliates the rejected party, and that the Constitution allows Congress to provide an action to redress such humiliations.²⁰⁰ If the requisite facts are proven, this action can be defeated only by showing that the remedy it provides would severely infringe other important rights of the discriminator. According to this reasoning the fact that some acts of discrimination result in greater injury than others is considered only in fashioning a remedy. The analysis that follows will suggest that the real badge of slavery imposed by discrimination in contracting is not the insult to the rejected party but the actual burden that such discrimination imposes on an individual. Sec-

¹⁹⁹ See note 195 *supra*.

In some ways the *McCrary* holding is less dangerous to private rights than a holding based on a public function theory of state action. But see *Private Education*, *supra* note 3; *Academies*, *supra* note 8. The result under a state action theory would infringe individual liberties no less than the *McCrary* result, but it would permit more analogies than the *McCrary* reasoning and therefore more invasions of personal liberties.

²⁰⁰ See note 187 *supra*.

tion 1981 should protect primarily against the imposition of such burdens.

The courts in *Riley* and *McCrary* read the phrase "right to contract" such that the right is infringed whenever one is refused a contract on the basis of race. This reading, alternative to the pre-*Jones*²⁰¹ reading that the right is violated only when the state refuses to give legal effect to a contract because of the race of one or both parties,²⁰² is not the only reasonable alternative. The simple refusal of an individual or organization to contract with another does not necessarily deprive the rejected party of his freedom, because the latter may be able to go elsewhere with little inconvenience or diminution of acceptable options. On the other hand, for example, "when racial discrimination herds men into ghettos and makes their ability to buy property turn on the color of their skin, then [the exclusion of Negroes from white communities] too is a relic of slavery."²⁰³ When nonwhites are in an inferior market position, the refusal of a white to contract with a nonwhite indeed imposes a substantial burden upon the nonwhite. The inferior bargaining position of the black is then a badge of slavery which marks him in all aspects of his business and social life.²⁰⁴

A far different situation would exist if the income and employment levels of blacks were equivalent to those of whites and if blacks were not largely confined to inferior housing in urban ghettos or depressed rural areas. Then the refusal to sell land to a black, or to hire him for a job, would not bear such long-term consequences and would not contribute to a string of insults to the black person's dignity.

An inferior position in a given market is defined essentially as one's inability to make and enforce contracts as favorable as those available to most other contractors in the same market. When such a general disability is attributable to a factor complete-

²⁰¹ *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409 (1968).

²⁰² See text accompanying notes 29 & 30 *supra*.

²⁰³ *Jones v. Alfred H. Mayer Co.*, 392 U.S. 409, 442-43 (1968).

²⁰⁴ The *Jones* Court recognized the importance of racial restrictions in the private housing market, though the holding does not depend on this recognition. Similar observations might have been made about the job market, to which the Court has recently applied § 1981. *Johnson v. Railway Express Agency, Inc.*, 95 S. Ct. 1716 (1975). Congress recognized the inferior position of nonwhites in the job and housing markets in Title VII of the 1964 Civil Rights Act, 42 U.S.C. § 2000e *et seq.* (1970), and Title VIII of the 1968 Civil Rights Act, 42 U.S.C. § 3601 *et seq.* (1970). (These acts were based on the commerce power rather than the thirteenth amendment. See *Heart of Atlanta Motel, Inc. v. United States*, 379 U.S. 241 (1964); *Katzenbach v. McClung*, 379 U.S. 294 (1964).)

ly beyond the control of the actor, such as the accident of race, his right to contract is denied more clearly than when he is merely denied the opportunity to make a single contract for the same reason. When such a blanket disadvantage exists, a class of contracts is closed to the actor or open to him only on unfavorable terms,²⁰⁵ so that his range of options is substantially narrowed. He is presented with a genuine obstacle to achieving a legitimate personal or business goal because of race, and such an obstacle is an incident of slavery.

It may be more difficult to establish the generally inferior position of blacks in the education market than in the housing or employment markets. Because of the tradition of local control of education, patterns in education markets may be much more fragmented than in jobs or housing, so that courts will not be able to take the kind of "judicial notice" of educational conditions that they have taken in the other fields.²⁰⁶

If in a given case a black plaintiff proves that he was denied a contract for education on the basis of race and that because of this he was placed in an inferior position in the market for education, he has made out a far stronger case for relief than a person who asserts only a denial of contract based on race. Colin Gonzalez, one of the plaintiff children in *McCrary*, in fact gained admission to another private school in the area.²⁰⁷ Although the fact of making a single contract is no more proof of good market position than is a single denial proof of a bad one, at least it demonstrates that the plaintiffs may have retained the ability to pursue desired options as effectively as most other contractors in the marketplace. If this is true, their right to contract has not been infringed in the sense under consideration. If, however, their ability to find a school to their liking is substantially inferior to that of similarly situated whites, then their right to contract for the purpose of education has been infringed.

If the "right to contract" is interpreted as the right to an equal position in the marketplace, which in this context means a choice of schools substantially as wide as that enjoyed by whites on equally favorable terms, then either an additional evidentiary requirement has to be imposed on plaintiffs in order to prove a

²⁰⁵ The unfavorable terms would not necessarily have to be, and usually would not be, economic terms. Rather, school administrators or admissions officers might avail themselves of more subtle, perhaps psychological, means of establishing their authority over black students that they would not employ with white students.

²⁰⁶ See note 204 *supra*.

²⁰⁷ 363 F. Supp. at 1202.

cause of action, or an additional defense would have to be available to their adversaries. Plaintiffs in cases like *McCrary* might be required to show disadvantage in the education market; alternatively, defendants who have discriminated might be allowed to show that their victims suffered no market disadvantage. Justice requires that the market showing be asserted as a defense rather than as an additional part of the plaintiff's burden. Discrimination, even when arguably legal, is repugnant to the national moral sense as expressed in the thirteenth amendment to the Constitution; an individual claiming a right to discriminate should be required to prove the harmlessness of his actions in the market terms described above.²⁰⁸

The form that the market evidence must take will have to be developed in the cases. Proof for a *McCrary*-type plaintiff might be relatively easy in a locality like that of *Cook v. Hudson*, where the only non-public school available is segregated;²⁰⁹ it would be quite difficult for a defendant there to prove no damage from his discrimination. Proof of effect may be even easier in areas where there are many segregated academies and little public support for predominantly black public schools.²¹⁰ In other areas, where many private schools are integrated, problems of proof will be more difficult. For example, simply showing a disproportion of the number of whites and blacks at private schools in an area may not prove a market effect of discrimination or rebut evidence showing no effect. Disproportions will need to be shown after controlling for those factors normally associated with private school entrance qualifications, such as ability to pay, tested I.Q. level (at certain types of school), religion (if the local private education market is dominated by religious schools), and others. These disproportions will not always need to be shown at

²⁰⁸ A similar shift of burden has been approved by the Supreme Court in *Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). In employment cases under Title VII of the Civil Rights Act, 42 U.S.C. § 2000e *et seq.* (1970), once a plaintiff shows the discriminatory effect of an employment practice, the defendant employer must demonstrate that the practice has a business justification. The plaintiff need not show that the employer had discriminatory motives.

²⁰⁹ Note 105 *supra* & accompanying text.

Whether public schools are part of the relevant market for these purposes depends on the schools in question. For example, if a public school provided education of the same kind and quality as a private school in the same locale, it would be part of the same market. (An incidental benefit to the public schools might flow from this formulation: If public schools had to be equal in quality to the private schools in order to maintain the right of the private schools to remain segregated, parents who wish to send their children to segregated private schools would have less reason to oppose supporting the public schools with their tax dollars.)

²¹⁰ See *Academies*, *supra* note 8.

the allegedly discriminatory school, but at the other private schools in the locality.

The advantages of this reading of "right to contract" are fairly clear. It requires proof of actual damage to the plaintiff in one of his activities, transforming the content of "badge of slavery" from insult to more concrete harm. Some private discriminatory conduct will not be reached under this reading, but discrimination will be reached whenever defendants fail to establish that their conduct did not hamper plaintiffs' ultimate attainment of their goals. Most importantly, this theory will substantially reduce the objections to enforcement of section 1981 which may tend to limit rights of autonomy. As the Supreme Court has noted, upholding certain associational rights may be at the expense of others' associational rights.²¹¹ Enforcement of "equality rights," which substantially restricts another individual's actions or opportunity for action, can be justified more easily when concrete, objectively discernible injury is required than when the only injury is insult. When this type of proof is required, it will be more acceptable to shift the balance to favor the rights of plaintiffs under the thirteenth amendment more heavily against discriminators claiming rights of autonomy. Of course, interpreting section 1981 in this way will not diminish the infringement of rights of autonomy in cases in which plaintiffs prove that they were disadvantaged in obtaining a quality education to their satisfaction; the interpretation suggested here will only decrease the number of successful plaintiffs and affected defendants. Should a plaintiff force desegregation of the Calhoun Academy of the *Hudson* case, the autonomy rights of parents, educators, and students will be infringed to exactly the same degree under this interpretation as under the *McCrary* majority's reading of the statute.

The suggested interpretation of section 1981 contains some disadvantages. First, it is inconsistent with the theory of most of the section 1981 cases decided to date, which hold the statute to be violated whenever a black cannot make a contract because of his race.²¹² Results under the suggested reading will, however, mostly be consistent with the results of most of these cases; they will differ only when plaintiffs fail to prove adverse consequences in the market.

Second, and more importantly, this reading would intro-

²¹¹ *Gilmore v. City of Montgomery*, 417 U.S. 556, 575 (1974).

²¹² See notes 38-47 *supra* & accompanying text.

duce an anomaly into the law in that it might be difficult for the prospective defendant to predict the legal consequences of his behavior. Whether a single discriminatory act would be actionable under the proposed reading of section 1981 would depend on factors beyond the control of the discriminator, such as whether and to what extent other individuals and organizations providing the same service discriminate.²¹³ The potential discriminator might not know about racial conditions in the relevant market. Although it is regrettable that one may not know the consequences of one's conduct in all cases, the strong constitutional and societal position against racial bias dictates that the courts not be unwilling to require discriminators to act at their own risk.

Another difficulty arises in defining the relevant market. In an area such as private education the differences between institutions are often significant because the whole object of the enterprise is to provide alternatives to standardized public school methods. For example, assume that a nonwhite sought to place his child in a "three R's" school in a community in which several progressive private schools were integrated, most of the traditional schools were not, and the public schools were grossly inferior. A court should probably hold that because educational decisions generally are protected by the right of autonomy, the plaintiff's assertion that he sought only a conservative school must be respected as a legitimate choice; the smaller group of traditional private schools would be the relevant market. This process of definition must be undertaken on a case by case basis.

A final difficulty, more political than legal, is that the suggested reading of section 1981 would probably force many Southern private schools and schools in small communities to integrate while leaving the North and schools in cities virtually untouched.²¹⁴ Some degree of regional ill-will would doubtless redound from this policy, but not as much as there might have

²¹³ For example, assume a market of three equivalent private schools. Defendant school is segregated but takes every white who applies. The other schools are integrated but accept only students who score above 100 on a standardized admissions test. Plaintiff scored below 100, was denied admission to the defendant school, and could thus make out a case under the suggested formulation. A black student who scored above 100, however, would not have a successful cause of action because of the existence of the other schools which would have admitted him.

Under this approach the general injunction against discrimination presently employed in § 1981 cases, including *McCrary*, might not be appropriate. Injunctions would have to be tailored more closely to particular situations.

²¹⁴ Note that this is also a problem with the public function theory of state action suggested in *Academies*, *supra* note 8, and *Private Education* *supra* note 3.

been before the federal courts became as concerned with de facto segregation in the North as with the more formal discriminatory schemes in the South.²¹⁵

In summary, the suggested reading of section 1981 has both advantages and drawbacks. It must be decided whether the added protection given rights of autonomy justifies section 1981's constricted coverage of private discrimination, the increased complexity of litigation, and the introduction of certain anomalies into the law. If, however, this reading is adopted, rights of autonomy claimed by discriminating educators and parents will not stand when the requirements of the rule are satisfied. This rule would require that the judgment in *McCrory* be vacated and the case remanded for findings about the education market in Northern Virginia.²¹⁶

IV. CONCLUSION

When discrimination in private education exists, it imposes a badge of slavery on the victims according to the sense of that term since *Jones v. Alfred H. Mayer Co.*²¹⁷ Most courts that have interpreted section 1981 have reasoned that any discrimination in private education based on race imposes a badge of slavery. The difference between the formulation followed in *McCrory* and that developed in this Comment is in the degree of actual damage that must be shown in order to merit relief under the statute. The more stringent requirement of concrete harm is preferable because it ensures that constitutional rights will be invaded only when their exercise would occasion serious infringements of others' constitutional right to equality of treatment under the law.

²¹⁵ See, e.g., *Keyes v. School Dist. No. One*, 313 F. Supp. 61 (D. Colo. 1970) (opinion on the merits) and 313 F. Supp. 90 (D. Colo. 1970) (opinion on remedies), *aff'd in part and rev'd in part*, 445 F.2d 990 (10th Cir. 1971), *modified and remanded*, 413 U.S. 189 (1973).

²¹⁶ If the Court of Appeals in *Riley* reverses the trial court's finding of fact, a similar factual determination would have to be made on remand there.

²¹⁷ 417 U.S. 556 (1974).

EDUCATIONAL MALPRACTICE

I. INTRODUCTION

In 1959, Columbia University sued a student and his parents to recover \$1,000 for tuition owed to the university.¹ The student filed a counterclaim demanding damages of \$7,016, alleging that the university "had represented that it would teach the defendant wisdom, truth, character, enlightenment, understanding, justice, liberty, honesty, courage, beauty and similar virtues and qualities; that it would develop the whole man, maturity, well-roundedness, objective thinking and the like; and that because it failed to do so it was guilty of misrepresentation, to defendant's pecuniary damage."² The trial court granted the university's motion for summary judgment and was sustained on appeal.³

In 1972, a young man with an average or above average IQ and an average attendance record was graduated from a San Francisco public high school after having attended San Francisco public schools for twelve years. He had a reading ability of approximately fifth-grade level.⁴ During his period of attendance in the San Francisco public schools, the student's parents attempted to obtain information about his educational progress and were repeatedly assured that he was performing at or near grade level.⁵ The student, alleging that his inability to read and write resulted from the negligence of his teachers and other school district employees,⁶ sued the school district and its employees to recover damages of over \$500,000.⁷ The trial judge sustained a demurrer to the complaint without opinion,⁸ and the case is now on appeal.

¹ Trustees of Columbia Univ. v. Jacobsen, 53 N.J. Super. 574, 148 A.2d 63 (App. Div.), *aff'd*, 31 N.J. 221, 156 A.2d 251 (1959).

² *Id.* at 576, 148 A.2d at 64.

³ *Id.*

⁴ First Amended Complaint at 4-5, Doe v. San Francisco Unified School Dist., No. 653-312 (Cal. Super. Ct., Sept. 6, 1974) [hereinafter cited as Complaint].

⁵ *Id.*

⁶ Plaintiff's Memorandum in Response to Defendants' Demurrer at 1, Doe v. San Francisco Unified School Dist., No. 653-312 (Cal. Super. Ct., Sept. 6, 1974) [hereinafter cited as Plaintiff's Memorandum].

⁷ Complaint, *supra* note 4, at 17.

⁸ Doe v. San Francisco Unified School Dist., No. 653-312 (Cal. Super. Ct., Sept. 6, 1974), *appeal docketed*, Civil No. 36851, 1st Dist. Ct. App., Apr. 28, 1975.

Although aspects of each of these suits may seem frivolous or implausible, these cases raise the issue whether a student can recover from a teacher, an administrator, a school, or school district for his failure to learn because of teacher negligence or incompetence.⁹ This Comment will explore various theories upon which a student might base such a suit. It will focus on the public school context in order to allow the development of the fullest range of legal theories and policy arguments and to present most of the legal and policy objections that can be raised against such a suit.

There is virtually no law in this area. The legal basis for this kind of action will be constructed from general principles of tort and contract law and by analogy to the law of professional malpractice. This Comment will outline a broad range of arguments, will indicate the strengths and weaknesses of each argument, and will suggest the situations in which each argument would be most useful.

II. PUBLIC SCHOOLS

In the public school context, an action for failure to learn addresses the general problem of providing a remedy to public school students for the loss of educational benefits because teachers negligently or intentionally failed to conform to minimum standards of professional competence in the same or similar communities.¹⁰ This loss of educational benefits results in the harm of the failure of a student or class of students to attain the educational level they probably would have attained had their teacher performed at the required level. Such a suit does not rest on the assumption that students will not learn at all without teachers or even that teachers are the most significant determinant of how much children learn.¹¹ The harm that a suit of this type could be brought to remedy is the loss of the difference a teacher makes in how much a student learns.

Because the standard to be applied is based on the minimum acceptable level of competence existing within the community or comparable communities, such a suit is probably not an effective approach to a general upgrading of education in a

⁹ See *Suing for Not Learning*, TIME, Mar. 3, 1975, at 73, describing a University of Bridgeport student's suit to recover tuition, the cost of books, driving expenses, and legal fees. The student alleged that a required course was "worthless," that the school did not provide the course described in the catalog, and that she did not learn anything.

¹⁰ See text accompanying notes 94-104 *infra*.

¹¹ See generally C. JENCKS, *INEQUALITY* (1972).

community or to an equalization of per capita funding, teacher quality, and facilities among different schools or communities.¹² In other words, a student could not bring an action for failure to learn alleging that his school is inferior to one in a dissimilar district, but such a suit might be brought, for example, by a student or class of students in a prosperous community who fail to reach the eightieth percentile in a particular subject or by students in a poor school who are graduated from high school reading at a third-grade level.¹³ In either situation, a student may have been denied the benefit of minimally competent instruction and suffered the "harm" of not learning as much as he would have if the teacher had been competent.

A. Remedies

At least three kinds of relief might be sought in the public school context. A plaintiff might seek removal of an incompetent teacher (and replacement with a competent teacher); provision of, or payment for, remedial instruction; and/or monetary compensation for diminished future income due, for example, to plaintiff's relegation to menial employment because of his inferior education.

Removal of an incompetent teacher has the advantage of being relatively cost-free. Teacher contracts may contain a provision permitting dismissal "for cause," and a judicial finding of negligence or incompetence might permit invocation of the provision.¹⁴ Also, under the common law and/or statutes of most states, teachers (including tenured teachers) can be dismissed for incompetence.¹⁵ An injunction could be directed against either school officials, ordering dismissal, or against the teacher, enjoining him or her from teaching. This remedy seems to be available under the tort, contract, and possibly the mandamus theories which will be developed later in this Comment.¹⁶ While dismissal eliminates the possibility that the teacher will harm future students, however, it does nothing to make whole those students who have already been subjected to the teacher. This remedy also does not seem suitable where the reasons for the negligent performance are not of a continuing nature, that is, where there

¹² For a brief discussion of approaches to these broader problems, see Ratner, *Remedying Failure to Teach Basic Skills*, *INEQUALITY IN EDUC.*, June 1974, at 15.

¹³ See text accompanying notes 94-104, 237-40 *infra*.

¹⁴ See E. REUTTER & R. HAMILTON, *THE LAW OF PUBLIC EDUCATION* 450 (1970).

¹⁵ *Id.*

¹⁶ See text accompanying notes 76-218 *infra*.

is no strong likelihood that the teacher's performance will continue to be unsatisfactory.

Requiring a teacher, school, or school district to provide or pay for remedial instruction sufficient to bring the plaintiff-students up to the educational level they probably would have attained if they had had a minimally competent teacher¹⁷ has several advantages. First, plaintiffs would, in most cases, be made whole. Second, this remedy does not involve awarding "speculative damages."¹⁸ Third, given the probable infrequency of successful suits under the standards developed in this Comment, this remedy does not involve ruinous expense to the school district.

In the case of students who have been out of school for a number of years, remedial instruction might not fully compensate the students for the loss suffered. Suppose, for example, that the suit is based on the incompetence of an entire reading staff. The students left school reading (on average) at the third-grade level. With minimally competent instruction, they probably would have read at ninth-grade level.¹⁹ If these students have suffered several years of diminished earnings because of their lack of reading ability, remedial instruction alone will not provide compensation. In such a case, money damages for lost earnings might be sought. Damages would amount to the difference between plaintiff's actual earnings from the time of leaving defendant school to the point at which remedial instruction corrected the reading deficiency and his probable earnings during the same period had he not had a "teacher-caused" educational deficiency.²⁰ If the reading deficiency was never corrected, the damages might be the total diminution of plaintiff's lifetime earnings attributable to teacher negligence or incompetence.²¹ In the case of someone who was denied promotion specifically because of his "teacher-caused" educational deficiency, and was consequently relegated to an inferior position, damages might be the difference between his projected life-time earnings at the lower level and what he would have earned in the position he

¹⁷ See text accompanying notes 219-55 *infra*.

¹⁸ See *id.*

¹⁹ *Id.*

²⁰ *Id.* Presumably statistics correlating income and reading ability have been or could be compiled. This kind of relief should be sought only where an entire reading or math program was negligently taught, since it is doubtful that a single teacher's negligence could substantially affect a student's earning capacity.

²¹ See Complaint, *supra* note 4, at 19. The amount of lost earnings may be calculable on the basis of statistics comparing average lifetime earnings of people at one reading level with the earnings of people reading on a higher level.

was denied, or the difference in earnings during the period between the denial of promotion and remedy of the deficiency.²²

Numerous objections can be raised to the demand and award of monetary compensation for diminished earnings. First, proof of harm on an individual basis would be difficult if not impossible, even though the harm to the entire class might be demonstrable.²³ Second, in any individual case, even if harm is proven, the precise amount of damages necessarily would be speculative. Courts have refused to award damages which will eventually be of a fixed amount and susceptible of precise computation, but are nonascertainable at the time of trial.²⁴ Third, damages arguably should never exceed the combination of the cost of remedial instruction and earnings lost during the period of remedial instruction; before suffering an income loss, a plaintiff could have sought and paid for remedial instruction. Failure to have done so might be considered a negligent failure to avoid or minimize damages, possibly barring recovery for the avoidable damages.²⁵ Finally, the award of money damages for diminished earnings could be a potentially crushing burden upon a school district, especially in a class action.²⁶ In decid-

²² If the suit is brought under a contract theory, the damages recoverable would be either compensation for detriment suffered (*e.g.*, loss of earnings during the period a student who decides not to drop out of school attends school) or loss of the expected benefit of the bargain (*e.g.*, diminished future income).

²³ This greater ease in proving harm to the entire class would support a decision to bring a class action. The other advantages of the class action for this type of suit are (1) the reduced cost per student-plaintiff of a class action and (2) the increased possibility that the publicity generated by a class action could provoke political, legislative, or administrative action potentially more far-reaching than any judicially constructed remedy. See Ratner, *supra* note 12, at 16, 21 & n.20. The disadvantage of a class action is that the potential cost to the school district of a plaintiff's verdict and the antipathy and impatience that some judges feel toward class actions in general, *e.g.*, Katz v. Carte Blanche Corp., 496 F.2d 747 (3d Cir.) (Seitz, C.J., dissenting), *cert. denied*, 419 U.S. 885 (1974), may severely jeopardize chances of success on the liability issue.

²⁴ *E.g.*, Big Rock Mountain Corp. v. Stearns-Roger Corp., 388 F.2d 165, 170 (8th Cir. 1968); Fireside Marshmallow Co. v. Frank Quinlan Constr. Co., 213 F.2d 16 (8th Cir. 1954); Sioux Tribe v. United States, 84 Ct. Cl. 16 (1936), *cert. denied*, 302 U.S. 740 (1937) (court refused to award damages to Indian children for Government's breach of treaty obligation to provide educational facilities and competent teachers, because amount of damages could not be calculated with sufficient certainty). This dislike for speculative damages contrasts with the willingness of courts to allow juries to speculate on the monetary value of pain and suffering, which will never be precisely calculable.

²⁵ See W. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 65, at 422-24 (4th ed. 1971). This argument loses its strength in the context of a misrepresentation case in which the plaintiff alleges, for example, that he was passed through every grade with satisfactory reports and it was not until after graduation that he realized his deficiencies. See text accompanying notes 169-81 *infra*; see generally W. PROSSER, *supra* § 110.

²⁶ In *Doe v. San Francisco Unified School Dist.*, No. 653-312 (Cal. Super. Ct., Sept. 6, 1974), *appeal docketed*, Civil No. 36851, 1st Dist. Ct. App., Apr. 28, 1975, damages

ing whether to impose liability on the basis of legal theories as novel as those upon which a plaintiff must rely in a suit for failure to learn, a court would certainly consider the potential crippling effect of a large damage award on public education. By demanding money damages for lost earnings, past and future, a plaintiff might diminish his chances of success on the basic liability issues.²⁷ It might, therefore, be advisable either to bring a suit for money damages only where remedial instruction would not be feasible, or to defer demands for money damages for diminished earnings to suits brought after liability has been established in suits for teacher dismissal and remedial instruction.

In *Doe v. San Francisco Unified School District*, the plaintiff sought money damages for mental distress, pain, and suffering arising from his "teacher-caused" reading deficiency.²⁸ Although courts have recently recognized the intentional infliction of mental distress as a basis for tort recovery,²⁹ courts generally have not permitted recovery for negligently inflicted mental distress without accompanying physical injury.³⁰ The demand in *Doe* seems to go far beyond any recovery allowed by courts in negligence suits, but it might be made more realistically in an intentional tort action.³¹ Even in the latter case, however, difficulties of proof may make success on this demand highly unlikely; moreover, seeking damages for mental distress may jeopardize chances for success on the crucial liability question.

B. Policy

A student's suit for failure to learn because of teacher negligence or incompetence³² cannot be won with formal legal arguments alone. Part of any plaintiff's case will have to be social policy arguments demonstrating why there should be liability.

Although the extent to which denial of education is an injury cognizable in tort or contract is unclear, courts have recognized the denial of education as a significant loss to a student.³³

for lost earnings, mental distress, and pain and suffering were calculated by the plaintiff to be \$500,000. Complaint, *supra* note 4, at 19.

²⁷ Interview with John G. Harkins, Jr., prominent Philadelphia trial attorney, in Philadelphia, Oct. 17, 1974.

²⁸ Complaint, *supra* note 4, at 19. See generally Ratner, *supra* note 12, at 16-17.

²⁹ W. PROSSER, *supra* note 25, § 12.

³⁰ *Id.* § 54, at 328-30.

³¹ See text accompanying notes 164-68 *infra*.

³² See text accompanying notes 69-218 *infra*.

³³ *Cf.* *Sioux Tribe v. United States*, 84 Ct. Cl. 16 (1936), *cert. denied*, 302 U.S. 740 (1937).

As the Supreme Court stated in *Brown v. Board of Education*,³⁴

Today, education is perhaps the most important function of state and local governments. Compulsory school attendance laws and the great expenditures for education both demonstrate our recognition of the importance of education to our democratic society. It is required in the performance of our most basic public responsibilities, even service in the armed forces. It is the very foundation of good citizenship. Today it is a principal instrument in awakening the child to cultural values, in preparing him for later professional training, and in helping him to adjust normally to his environment. In these days, it is doubtful that any child may reasonably be expected to succeed in life if he is denied the opportunity of an education.³⁵

Given the importance of education, lack of legal precedent should not be determinative. In the past, courts have expanded the tort law to create remedies for injuries not previously recognized in tort. Prosser writes,

The law of torts is anything but static, and the limits of its development are never set. When it becomes clear that the plaintiff's interests are entitled to legal protection against the conduct of the defendant, the mere fact that the claim is novel will not of itself operate as a bar to the remedy.³⁶

Courts have imposed liability for the intentional infliction of mental suffering,³⁷ for injuries caused by defective products,³⁸ for the infliction of prenatal injuries,³⁹ and for other injuries which do not fit into traditional tort categories. Thus if a plaintiff can convince a court that there should be liability as a matter of policy, the absence of formal legal precedents should not bar recovery in tort.⁴⁰

The primary function of the tort law is, as Prosser explains, "the allocation of losses arising out of human activities . . ."⁴¹ In

³⁴ 347 U.S. 483 (1954).

³⁵ *Id.* at 493.

³⁶ W. PROSSER, *supra* note 25, § 1, at 3-4 (footnote omitted).

³⁷ *Id.* § 12.

³⁸ *Id.* §§ 95-104.

³⁹ *Id.* §§ 55.

⁴⁰ For a model of how to fashion a new tort with a combination of policy and formal legal arguments, see Sax & Hiestand, *Stumlordism as a Tort*, 65 MICH. L. REV. 869 (1967). See also W. PROSSER, *supra* note 25, § 1, at 4 n.18, § 12, at 51.

⁴¹ W. PROSSER, *supra* note 25, § 1, at 6.

deciding if there should be liability in an action for failure to learn, we are deciding who should bear the educational "losses" caused by teacher negligence or incompetence.

Punishment or retaliation has been suggested as one aim of the tort law, that is, as one principle for deciding who should pay for losses.⁴² If the cost of making whole the student who has failed to learn because of teacher negligence is to be assigned in accordance with a punishment or retaliation principle, a blameworthy teacher or school district should bear the loss rather than the innocent student.

Some authorities suggest that losses should be assigned to the party better able to bear the costs, or should be shifted to the public at large.⁴³ A school district is obviously a better loss bearer than an individual student because it can pass on the cost of whatever remedy is awarded to the general public in the form of increased taxes. Rather than raising taxes, however, a municipality might lower the overall quality of education to pay for a major judgment in favor of a single student or class of students. But even if this were the case, spreading the injury among all students in the district or municipality is arguably more equitable than leaving the entire burden on the student(s) who had the misfortune of drawing an incompetent teacher. Furthermore, just as school districts are able to obtain liability insurance to cover physical injuries to students caused by the negligence of school employees, they could probably obtain insurance against the type of liability involved here, guaranteeing efficient cost spreading.⁴⁴ Even if, because of an immunity statute,⁴⁵ the school district is not held liable for the consequences of the teacher's negligence under the doctrine of *respondeat superior* or for its own negligence in hiring an incompetent teacher, malpractice insurance could be made available to teachers. The cost of the insurance could be passed on to the public through the mechanism of increased salaries paid with higher taxes.⁴⁶ Thus, the teacher himself appears to be a better risk bearer than the student.

⁴² *Id.* § 4, at 23 & n.81.

⁴³ *See id.* 22 & n.69.

⁴⁴ *See* Proehl, *Tort Liability of Teachers*, in PROFESSIONAL NEGLIGENCE 185, 202-03 (T. Roady & W. Andersen eds. 1960). Some cases and statutes now recognize that the availability of liability insurance eliminates the need to protect governments with immunity. *Johnston v. Girvin*, 61 Ill. App. 2d 47, 208 N.E.2d 894 (1965); *Thomas v. Broadlands Community Consol. School Dist.*, 348 Ill. App. 567, 109 N.E.2d 636 (1952); *Vendrell v. School Dist.*, 226 Ore. 263, 360 P.2d 282 (1961).

⁴⁵ Notes 70-75 *infra* & accompanying text.

⁴⁶ *Cf.* Proehl, *supra* note 44, at 202 & n.100.

It has been suggested that imposing liability for a student's failure to learn because of teacher negligence or incompetence would render public education economically infeasible.⁴⁷ For three reasons, this concern may be unjustified. First, this objection is inapplicable to demands for dismissal of incompetent teachers. Second, although a large class action suit would expose a school district to a potentially crushing burden if damages for prospective loss of income were awarded, the burden would not be nearly as great if only provision of or payment for remedial instruction were demanded. Third, since under the standards of negligence suggested in this Comment⁴⁸ a successful suit would probably be rare, the school district or individual teacher might be able to purchase insurance at a reasonable price.⁴⁹

It is possible that the costs of compensating a class of students or a single student for diminished income would, if provable, be so potentially burdensome as to make success on the liability question unlikely. If a damage judgment would substantially reduce the quality of services that the school district could provide, courts will most likely decide that the social need for educational services outweighs the interest of any particular plaintiff or class of plaintiffs in recovering for educational benefits denied by teacher negligence.

An obvious benefit of imposing liability on teachers, school officials, and school districts is the deterrence of negligent teaching and the hiring of incompetent teachers.⁵⁰ Personal liability, however, may also discourage people from becoming teachers.⁵¹ Although the availability of malpractice insurance may substantially eliminate fear of financial responsibility, it would not eliminate the "chilling effect" on entry into the profession generated by the fear of being disgraced in a courtroom by public testimony of incompetence.

Furthermore, liability resulting in monetary damages or dismissal may discourage the experimentation that leads to edu-

⁴⁷ Demurrer of Defendants on First Amended Complaint at 17, *Doe v. San Francisco Unified School Dist.*, No. 653-312 (Cal. Super. Ct., Sept. 6, 1974) [hereinafter cited as *Defendants' Demurrer*]. See also W. PROSSER, *supra* note 25, § 4, at 22-23.

⁴⁸ Text accompanying notes 94-104 *infra*.

⁴⁹ See generally Proehl, *supra* note 44, at 202.

⁵⁰ Cf. *Johnson v. State*, 69 Cal. 2d 782, 447 P.2d 352, 73 Cal. Rptr. 240 (1968), in which the California supreme court found this consideration persuasive: "An employee in a private enterprise naturally gives some consideration to the potential liability of his employer, and this attention unquestionably promotes careful work; the potential liability of a governmental entity, to the extent that it affects primary conduct at all, will similarly influence public employees." *Id.* at 792-93, 447 P.2d at 360, 73 Cal. Rptr. at 248.

⁵¹ See Comment, *Professional Negligence*, 121 U. PA. L. REV. 627, 657 (1973) [hereinafter cited as *Professional Negligence*].

cational progress.⁵² This problem may be overcome by giving parents the choice of putting their children in experimental classes; the doctrine of assumption of risk would then allow experimentation undeterred by the threat of damages or dismissal.⁵³ The threat of liability would have the beneficial effect of inducing school officials and teachers to explain experimental programs to parents and students in order to secure formal and voluntary consent sufficient to establish assumption of risk. Where, in the absence of formal consent, a teacher or school official decides to deviate from conventional practices, and, as a result, children suffer an educational loss, perhaps the victims of the unsuccessful experiment *should* be compensated or elevated to the educational level they probably would have attained with conventional instruction.⁵⁴ Depending on the circumstances of the particular case, a successful suit need not result in an injunction against experimentation or dismissal of the experimenting teacher. Payment for the costs of the unsuccessful experiment may, in many cases, be sufficient.⁵⁵

It might be argued that other, non-judicial mechanisms, such as political action, certification procedures, supervisory control, and professional review, are adequate to prevent or deter teacher negligence.⁵⁶ But to the extent that an educational malpractice suit has a basis in fact, these other mechanisms have been inadequate to prevent teacher negligence. In addition, most other procedures provide only prospective relief and none of them "make whole" students who have already been injured by teacher negligence.⁵⁷ Professional review boards have been suggested as a cheaper and more efficient way of enforcing professional standards and compensating individuals than the civil lawsuit.⁵⁸ Although fashioning an alternative compensation procedure may be desirable to eliminate the problems inherent in litigation—a slow, costly, and inefficient route⁵⁹—the shortcomings of the judicial process are not a valid reason to deny recovery in a lawsuit.

⁵² Cf. Wade, *The Attorney's Liability for Negligence*, in PROFESSIONAL NEGLIGENCE 238 & n.142 (T. Roody & W. Andersen eds. 1960).

⁵³ School districts might try to take advantage of this defense by requiring parents to sign a blanket waiver when their children enter kindergarten. It is far from certain, however, that such a waiver would be enforced. Cf. *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 386-403, 161 A.2d 69, 84-95 (1960).

⁵⁴ See text accompanying notes 219-40 *infra*.

⁵⁵ See text accompanying notes 252-55 *infra*.

⁵⁶ See, e.g., *Defendants' Demurrer*, *supra* note 47, at 17-18.

⁵⁷ See Sax & Hiestand, *supra* note 40, at 885-86.

⁵⁸ *Professional Negligence*, *supra* note 56, at 688-89.

⁵⁹ See Sax & Hiestand, *supra* note 40, at 875.

Another argument against recognition of a cause of action for failure to learn because of teacher negligence or incompetence focuses on the administrative inconvenience which might be caused by a "flood of litigation" involving difficult problems of proof. Various authorities, however, have rejected this argument as a legitimate reason for denying liability when genuine and serious injuries have occurred.⁶⁰ For example, Prosser writes, "It is the business of the law to remedy wrongs that deserve it, even at the expense of a 'flood of litigation' and it is a pitiful confession of incompetence on the part of any court of justice to deny relief on such grounds."⁶¹ Moreover, problems of proof may be no more insurmountable than those involved in other kinds of lawsuits that are presently recognized,⁶² and, under the standards of negligence outlined in this Comment,⁶³ a "flood of litigation" is unlikely.

In *Doe v. San Francisco Unified School District*,⁶⁴ defendants argued that the "social importance" of free, universal public education should bar recovery for negligence.⁶⁵ This argument has not prevented courts from holding school districts liable for physical injuries caused by teacher negligence,⁶⁶ and the courts have generally declined to allow the importance of a public function to determine whether tort liability for negligent performance exists.⁶⁷ Furthermore, if the costs of liability would not make public education economically infeasible (a factual question), there is no logical reason why the importance of public education should imply immunity.

In assessing the possible objections to recognizing this cause of action, the following observation of the Pennsylvania Supreme Court should be kept in mind:

Throughout the entire history of the law, legal
Jeremiahs have moaned that if financial responsibility

⁶⁰ *E.g.*, *Battalla v. State*, 10 N.Y.2d 237, 176 N.E.2d 729, 219 N.Y.S.2d 34 (1961); see W. PROSSER, *supra* note 25, § 12, at 51 & n.38.

⁶¹ W. PROSSER, *supra* note 25, § 12, at 51.

⁶² Text accompanying notes 219-55 *infra*.

⁶³ Text accompanying notes 94-104 *infra*.

⁶⁴ No. 653-312 (Cal. Super. Ct., Sept. 6, 1974), *appeal docketed*, Civil No. 36851, 1st Dist. Ct. App., Apr. 28, 1975.

⁶⁵ Defendants' Demurrer, *supra* note 47, at 17.

⁶⁶ *E.g.*, *Bellman v. San Francisco High School Dist.*, 73 P.2d 596 (1937), *aff'd on rehearing*, 11 Cal.2d 576, 81 P.2d 894 (1938); *Gardner v. State*, 281 N.Y. 212, 22 N.E.2d 344 (1939).

⁶⁷ *E.g.*, *Johnson v. State*, 69 Cal. 2d 782, 447 P.2d 352, 73 Cal. Rptr. 240 (1968). *But see* *Lipman v. Brisbane Elementary School Dist.*, 55 Cal.2d 224, 359 P.2d 465, 11 Cal. Rptr. 97 (1961).

were imposed in the accomplishment of certain enterprises, the ensuing litigation would be great, chaos would reign and civilization would stand still. It was argued that if railroads had to be responsible for their acts of negligence, no company could possibly run trains; if turnpike companies had to pay for harm done through negligence, no roads would be built; if municipalities were to be financially liable for damage done by their motor vehicles, their treasuries would be depleted. Nevertheless, liability has been imposed in accordance with elementary rules of justice and the moral code, and civilization in consequence, has not been bankrupted, nor have the courts been inundated with confusion.⁶⁸

C. *Legal Theories*

No reported case has allowed public school students to recover for the loss of educational benefits because of teacher negligence or incompetence. The legal bases for such an action must be created by analogy from the law of malpractice and by a somewhat novel application of general principles of tort and contract law. Although any law student can raise objections to each of the legal theories that will be outlined, the analysis that follows may give a judge a legal formula with which to explain a policy-based plaintiff's decision. A plaintiff's verdict would in fact be a recognition of a new tort or contract cause of action, but the framing of the suit in familiar language would increase a court's receptiveness by making such a verdict appear less radical.⁶⁹

In some jurisdictions, the plaintiff's task may be made much more difficult by continued adherence to the doctrine of governmental immunity from tort liability.⁷⁰ The extent to which the doctrine would bar an action of this type varies greatly from jurisdiction to jurisdiction. Where the doctrine is applied most broadly, teachers, school officials, and school districts have been held immune from liability for students' injuries caused by the

⁶⁸ *Doyle v. South Pittsburgh Water Co.*, 414 Pa. 199, 218-19, 199 A.2d 875, 884 (1964).

⁶⁹ W. PROSSER, *supra* note 25, § 6, at 27.

⁷⁰ See Memorandum of Defendants at 3, *McNeil v. Board of Educ.*, Civil No. L-17297-74 (N.J. Super. Ct., Essex County, filed Jan. 15, 1975), arguing that sovereign immunity should bar a former student's suit against a school board for the school system's alleged negligent failure to deal adequately with his reading and visual disability. See generally W. PROSSER, *supra* note 25, §§ 131-32; Proehl, *supra* note 44, at 185-86, 202-04.

negligent acts and omissions of teachers or school officials.⁷¹ Unquestionably, jurisdictions that bar liability for physical injuries would not allow liability for students' failure to learn. In some states, governmental immunity extends to school districts and officials but not to teachers.⁷² In other states, school districts are liable for injuries caused by the negligent acts and omissions of their teachers to the extent of the district's liability insurance coverage.⁷³ In still other states, the doctrine of governmental immunity has been generally abrogated and exists only where immunity is specifically provided for by statute;⁷⁴ in these states the teacher and the school district will generally be liable for injuries caused by the teacher's negligence. It suffices to point out that in at least some jurisdictions the doctrine does not absolutely bar actions against teachers, schools, and school districts to recover for injuries to students caused by teacher negligence, and that authorities have contended, as a matter of policy, that immunity doctrines should not insulate school districts, officials, and teachers from tort liability where liability insurance is available at non-crippling rates.⁷⁵

1. Tort Theories

Three broad areas of tort law are relevant to a cause of action for failure to learn because of teacher incompetence: negligence, intentional tort, and misrepresentation (deceit and negligent misrepresentation).

a. *Negligence*

Section 328 A of the *Restatement (Second) of Torts* sets forth the essential elements of a negligence suit:

In an action for negligence, the plaintiff has the burden of proving

(a) facts which give rise to a legal duty on the part of the defendant to conform to the standard of conduct estab-

⁷¹ E.g., *Carroll v. Lucas*, 39 Ohio Misc. 5, 313 N.E.2d 864 (C.P. 1974) (suit can be brought only with specific statutory authorization).

⁷² E.g., *Duncan v. Koustenis*, 260 Md. 98, 271 A.2d 547 (1970).

⁷³ See *Johnston v. Girvin*, 61 Ill. App. 2d 47, 208 N.E.2d 894 (1965); *Thomas v. Broadlands Community Consol. School Dist.*, 348 Ill. App. 567, 109 N.E.2d 636 (1952); *Vendrell v. School Dist.*, 226 Ore. 263, 360 P.2d 282 (1961). But see *Niedfelt v. Joint School Dist.*, 23 Wis. 2d 641, 127 N.W.2d 800 (1964).

⁷⁴ See, e.g., *Spanel v. Mounds View School Dist.*, 264 Minn. 279, 118 N.W.2d 795 (1962).

⁷⁵ See, e.g., *Duncan v. Koustenis*, 26 Md. 98, 271 A.2d 547 (1970); Proehl, *supra* note 44, at 202-03.

lished by law for the protection of the plaintiff,
(b) failure of the defendant to conform to the standard of conduct,
(c) that such failure is a legal cause of the harm suffered by the plaintiff, and
(d) that the plaintiff has in fact suffered harm of a kind legally compensable by damages.⁷⁶

Phrased differently, these elements are (1) a negligent act or omission, (2) a legally recognized harm, (3) cause in fact, (4) proximate cause, and (5) duty.⁷⁷

A suit against a teacher to recover damages for a student's failure to learn because of teacher incompetence can easily be framed in the language of a typical negligence suit.⁷⁸ At the very least, the plaintiff's case would involve establishing that the student's failure to learn is a "harm"⁷⁹ cognizable in tort, that the teacher was negligent,⁸⁰ that "but for" that negligence the student would not have suffered this harm,⁸¹ and that the teacher had a duty to teach the student non-negligently.⁸² Proximate cause is self-evidently present under most interpretations of the term.⁸³ A student's failure to learn is clearly among the foreseeable risks of a teacher's poor classroom methods, thus satisfying one formulation of the term.⁸⁴ Under the second major in-

⁷⁶ RESTATEMENT (SECOND) OF TORTS § 328A (1965).

⁷⁷ It is recognized that "duty," in this case duty to teach non-negligently, is a conclusory term. It is not clear whether it has a meaning independent of the concepts of negligence and proximate cause. Prosser writes:

The statement that there is or is not a duty begs the essential question—whether the plaintiff's interests are entitled to legal protection against the defendant's conduct. . . . It is a shorthand statement of a conclusion, rather than an aid to analysis in itself. . . . [I]t should be recognized that "duty" is not sacrosanct in itself, but only an expression of the sum total of those considerations of policy which lead the law to say that the particular plaintiff is entitled to protection.

W. PROSSER, *supra* note 25, § 53, at 325-26 (footnotes omitted). Nonetheless, this Comment will retain the term, since it is used by the judges whom the following arguments are intended to persuade.

⁷⁸ See Complaint, *supra* note 4, at 6-8.

⁷⁹ Text accompanying notes 219-55 *infra*.

⁸⁰ Text accompanying notes 94-104 *infra*.

⁸¹ Text accompanying notes 219-36 *infra*.

⁸² Text accompanying notes 105-63 *infra*.

⁸³ The defendants in *Doe v. San Francisco School Dist.*, No. 653-312 (Cal. Super. Ct., Sept. 6, 1974), *appeal docketed*, Civil No. 36851, 1st Dist. Ct. App., Apr. 28, 1975, conceded this point. See Defendants' Demurrer, *supra* note 47, at 14.

⁸⁴ The area within which liability is imposed is that which is within the circle of reasonable foreseeability using the original point at which the negligent act was committed or became operative, and thence looking in every direction as the semi-diameters of the circle, and those injuries which from this point could or

terpretation, proximate cause exists because a student's failure to learn is a direct consequence of the teacher's incompetent teaching.⁸⁵ Unlike many novel tort claims, this type of suit does not involve injuries of a remote or unforeseeable character.

Assuming that the plaintiff is not barred by governmental immunity,⁸⁶ the liability of the school district or municipality could be asserted under at least two theories. First, the doctrine of *respondeat superior* (either common law or statutory) may render the school district or municipality vicariously liable for the negligent acts and omissions of its teacher/employees.⁸⁷ In some jurisdictions where the doctrine is not available, the teacher may have a statutory right to indemnification for losses incurred in a negligence judgment arising out of the teacher's employment.⁸⁸ Second, the doctrine of *respondeat superior* may be invoked to render the school district liable for the negligence of its officials in hiring an incompetent teacher⁸⁹—an act that was the cause in fact of the student's educational loss.⁹⁰ Proximate cause would not be an obstacle, since the failure of the student to learn is clearly a direct and foreseeable consequence of the hiring of an incompetent teacher. Moreover, cases involving recovery for physical injuries caused by teacher negligence have shown that a court is more likely to find for the plaintiff on the liability issue if there is a legal basis for either the direct or derivative liability of the school district.⁹¹

Presumably, the usual tort defenses of contributory negligence and assumption of risk would be available. The methods of proof suggested in this Comment, however, may eliminate

should have been reasonably foreseen as something likely to happen, are within the field of liability, while those which, although foreseeable, were foreseeable only as remote possibilities, those only slightly probable, are beyond and not within the circle, —in all of which time, place and circumstance play their respective and important parts.

Mauney v. Gulf Ref. Co., 193 Miss. 421, 428-29, 9 So.2d 780, 781 (1942).

⁸⁵ "Direct" consequences are those which follow in sequence from the effect of the defendant's act upon conditions existing and forces already in operation at the time, without the intervention of any external forces which come into active operation later." W. PROSSER, *supra* note 25, § 43, at 263-64 (footnote omitted). See generally *id.* 251-70.

⁸⁶ See text accompanying notes 70-75 *supra*.

⁸⁷ E.g., Bellman v. San Francisco High School Dist., 73 P.2d 596 (1937), *aff'd on rehearing*, 11 Cal. 2d 576, 81 P.2d 894 (1938); Cherney v. Board of Educ., 31 App. Div. 2d 764, 297 N.Y.S.2d 668 (1969); CAL. GOV'T CODE § 815.2 (West 1966).

⁸⁸ See, e.g., N.Y. EDUC. LAW § 3023 (McKinney 1970); Proehl, *supra* note 44, at 203.

⁸⁹ See Proehl, *supra* note 44, at 202.

⁹⁰ See, e.g., Engel v. Gosper, 71 N.J. Super. 573, 177 A.2d 595 (Super. Ct. 1962); Kolar v. Union Free School Dist., 8 N.Y.S.2d 985 (Madison County Ct. 1939).

⁹¹ Proehl, *supra* note 44, at 215-16.

the factual basis for a contributory negligence defense.⁹² In some jurisdictions, the availability of both these defenses may be limited by precedent or statute making it impossible for a child below a certain age to be contributorily negligent or assume the risk.⁹³

(i) Negligence—The Standard

Professional liability cases within and without the education area suggest the standard by which teachers' professional conduct should be judged:⁹⁴ They "must have the skill and learning commonly possessed by members of the profession in good standing."⁹⁵ In most states, this standard depends on where the defendant practices; usually he will be required to exercise only that degree of skill and training ordinarily possessed by members of the profession in his own or similar communities.⁹⁶ When members of the profession disagree about which practices or procedures are correct, the professional will usually be judged by the school of thought to which he adheres, provided the school is "a recognized one with definite principles, and it must be the line of thought of at least a respectable minority of the profession."⁹⁷

Thus, a professional will be judged not by the "reasonable man" standard applied in ordinary negligence cases, but by comparison with his professional peers. In an ordinary negligence case, the jury may find that a defendant who conformed to the normal or average conduct of the community was nonetheless negligent. In a professional malpractice case, conformity to the norm or minimum of the professional community is by definition non-negligent, even though the jury may believe that the community norm or minimum is too low.⁹⁸ This comparative standard, holding teachers to only a community norm or minimum, should keep the number of educational malpractice suits within reasonable limits.

⁹² Text accompanying notes 219-55 *infra*.

⁹³ See W. PROSSER, *supra* note 25, § 32, at 156-57, § 65, at 419 & n.31, § 68, at 447 & n.82.

⁹⁴ See generally PROFESSIONAL NEGLIGENCE (R. Roedy & W. Andersen eds. 1960).

⁹⁵ W. PROSSER, *supra* note 25, § 32, at 162; *accord*, RESTATEMENT (SECOND) OF TORTS § 299A (1965); *Professional Negligence*, *supra* note 51, at 633.

⁹⁶ W. PROSSER, *supra* note 25, § 32, at 164.

⁹⁷ *Id.* 163; *accord*, RESTATEMENT (SECOND) OF TORTS § 299A, comment *f* at 75 (1965).

⁹⁸ *But see Professional Negligence*, *supra* note 51, at 639, arguing that the community standard has been limited and that a minimum level of competence may be required regardless of the level of the community.

Indeed, this definition of negligence is probably under-inclusive, because, especially in poor schools, the minimum level of teaching may be so low that many incompetent teachers will inevitably be deemed non-negligent. This standard therefore negates the possibility of using a negligence suit to achieve a general upgrading of ghetto education; the performance of the majority of ghetto schools and teachers will be, by definition, within the minimum standards of the professional community by which the teacher's performance is evaluated. It is not clear, however, that a negligence action is the appropriate legal base for a general attack upon low quality education. Applying the minimum standards of the professional community, a negligence action will at least provide a remedy for the very worst cases.

In suits against teachers to recover for physical injuries caused by inadequate teacher supervision, the conduct of the teacher has been judged by the usual tort standard of care—that of a “reasonable and prudent person acting under like circumstances.”⁹⁹ But in suits to recover for physical injuries to students caused by negligent instruction, the standard of negligence usually applied is similar to the general professional standard stated above.¹⁰⁰ In a suit to recover for a student's failure to learn because of teacher negligence, the standard of acceptable instruction should be comparative, that is, the level of skill and learning of the minimally acceptable teacher in the same or similar communities.¹⁰¹ Unlike the supervision cases, this kind of suit may require a jury to evaluate the professional methods employed by the teacher, and the general professional standard is more suitable than the “reasonable man” standard for evaluating exercises of professional discretion and judgment.¹⁰² In addition, this standard will not inhibit the adoption of new teaching methods which have won acceptance by “a respectable minority of the profession.”

Section 308 of the *Restatement (Second) of Torts* suggests the

⁹⁹ Proehl, *supra* note 44, at 204-07.

¹⁰⁰ *E.g.*, *Gardner v. State*, 281 N.Y. 212, 22 N.E.2d 344 (1939).

¹⁰¹ As Prosser notes, it is misleading to say that the appropriate standard is the level of skill and learning possessed by the *average* member of the profession: “only those in good professional standing are to be considered; and of these it is not the middle but the minimum common skill which is to be looked to.” W. PROSSER, *supra* note 25, § 32, at 163. It would be especially unwise to apply an “average” standard in a suit to recover for negligent instruction, because such a standard would define a large number of teachers as negligent. The standard of the minimally acceptable teacher is much more likely to receive judicial acceptance.

¹⁰² See *Professional Negligence*, *supra* note 51, at 643-44.

proper standard for determining the negligence of school officials who hire incompetent teachers:

It is negligence to permit a third person to . . . engage in an activity which is under the control of the actor, if the actor knows or should know that the person intends or is likely . . . to conduct himself in the activity in such a manner as to create an unreasonable risk of harm to others."¹⁰³

Under this standard, a school official would be liable for hiring a teacher he knew or should have known was incompetent or likely to teach negligently. Adoption of the "known or should have known" standard for school officials would likely have the beneficial effect of closer supervision of the classroom and the results produced in the classroom.

Proof of negligence, as will be explained, may involve expert testimony, evidence of failure to adhere to statutorily prescribed standards, and circumstantial evidence (inferences from unsatisfactory results).¹⁰⁴

(ii) Legal Precedents

Various statutory, common law, and scholarly authorities support the contention that school districts and teachers should be held liable for the failure of students to learn because of the negligence of the teacher. These authorities affirm the existence of a duty of non-negligent instruction and the cognizability in tort of this type of harm.

Courts in many jurisdictions have held teachers and school districts liable for physical injuries to students caused by negligent conduct within the scope of the teacher's employment.¹⁰⁵ Typical teacher negligence cases involve injuries arising from a lack of adequate teacher supervision.¹⁰⁶ In these cases, the teacher has been held to the standard of a "reasonable and prudent person acting under like circumstances."¹⁰⁷ Although under most circumstances a person does not have a duty to take affirmative action to protect others from a risk of harm which the person did not create, a special relationship between the parties, including the student-teacher relationship, has given rise to

¹⁰³ RESTATEMENT (SECOND) OF TORTS § 308 (1965).

¹⁰⁴ Text accompanying notes 219-55 *infra*; W. PROSSER, *supra* note 25, §§ 37-40.

¹⁰⁵ See Proehl, *supra* note 44.

¹⁰⁶ See *id.* 204-07.

¹⁰⁷ *Id.* 201.

such a duty.¹⁰⁸ These cases support the general notion that a teacher may be liable to students for the foreseeable consequences of his negligent teaching.¹⁰⁹

Another important line of cases has found liability where a student suffers physical injury because he was negligently instructed by a gym teacher. In *Gardner v. State*,¹¹⁰ for example, the state of New York was held liable for injuries sustained by a student attempting to perform a gymnastic stunt proximately caused by the failure of the gym teacher to follow customary methods of instruction. In a New Jersey case, the court upheld the legal sufficiency of the complaint in a suit against two science teachers and the school board to recover for a student's injuries and eventual death caused in part by the negligent failure of the teachers properly to instruct the student in the use of rockets.¹¹¹ These cases, recognizing the legal duty of teachers to adhere to professionally acceptable (non-negligent) methods of instruction,¹¹² are precedent for judicial evaluation of teaching quality and for the liability of teachers and their employers for the consequences of negligent instruction.

One might contend that this duty of non-negligent instruction exists only where the consequences of negligent instruction involve a risk of serious physical injury. Preventing failure of a student to learn, however, is arguably no less important than preventing physical injuries;¹¹³ moreover, the tort law does not recompense only physical injuries.¹¹⁴ Defamation, invasion of privacy, unfair competition, and legal malpractice are some areas of tort law where recovery is permitted for non-

¹⁰⁸ See W. PROSSER, *supra* note 25, § 56, at 341-42, 348-49.

¹⁰⁹ Cf., e.g., *Morgan v. County of Yuba*, 230 Cal. App. 2d 938, 41 Cal. Rptr. 508 (Dist. Ct. App. 1964); *Proehl, supra* note 44, at 190 n.27.

¹¹⁰ 281 N.Y. 212, 22 N.E.2d 344 (1939); see *Bellman v. San Francisco High School Dist.*, 73 P.2d 596 (1937), *aff'd on rehearing*, 11 Cal. 2d 576, 81 P.2d 894 (1938); *Smith v. Consolidated School Dist.*, 408 S.W.2d 50 (Mo. 1966); *Keesee v. Board of Educ.*, 37 Misc. 2d 414, 235 N.Y.S.2d 300 (Sup. Ct. 1962).

¹¹¹ *Engel v. Gosper*, 71 N.J. Super. 573, 177 A.2d 595 (Super. Ct. 1962). The bases for the school board's liability were the doctrine of *respondeat superior* and negligence in hiring unsuitable teachers. See also *Klenzendorf v. Shasta Union High School Dist.*, 4 Cal. App. 2d 164, 40 P.2d 878 (Dist. Ct. App. 1935).

¹¹² Curran, *Professional Negligence—Some General Comments*, in PROFESSIONAL NEGLIGENCE 4 (T. Roady & W. Andersen eds. 1960); accord, *Lucas v. Hamm*, 56 Cal. 2d 583, 643 P.2d 685, 15 Cal. Rptr. 821 (1961); RESTATEMENT (SECOND) OF TORTS § 299 A & comment c at 73-74 (1965). Another way to describe the "duty" to which the professional relationship gives rise is that conformity to the standards of the profession is an implicit term of the contract that arises between the professional and his client, patient, student, etc. See *Professional Negligence, supra* note 51, at 679; text accompanying note 183 *infra*.

¹¹³ See text accompanying notes 33-40 *supra*.

¹¹⁴ See generally *Sax & Hiestand, supra* note 40, at 879-86.

physical injuries.¹¹⁵ In the education context, courts have held school authorities liable for the intentional infliction of mental distress on a student.¹¹⁶

Both Prosser and the *Restatement (Second) of Torts* assert that when someone undertakes to render a service to another upon which the other relies, the actor assumes a duty to act non-negligently and will be liable for harm that results from negligent performance.¹¹⁷ Prosser writes, "Where performance clearly has been begun, there is no doubt that there is a duty of care."¹¹⁸ Applied to education, this formulation suggests that once a teacher, school, and school district undertake to provide education, they assume a duty to educate non-negligently. This general principle of voluntary assumption of duty has been applied specifically to government undertakings in a variety of cases. *Indian Towing Co. v. United States*¹¹⁹ expresses the notion that the government will be liable for providing a service in a negligent manner, even though it was under no obligation to provide the service at all. This case held that when the Coast Guard exercised its discretion to operate a lighthouse, it was liable for damages resulting from the negligent failure to keep the light in good working order. In a California case, a county sheriff who made a gratuitous promise to warn the plaintiff of the release of a dangerous prisoner was held liable for injuries sustained by the plaintiff when the sheriff negligently failed to give the warning.¹²⁰ Another California case held that the owner of a boat marina could bring an action against the state for damages resulting from the negligent preparation and release of weather and flood information.¹²¹ Similarly, when the state and its employees undertake to provide education, they assume a duty to do so non-negligently.¹²²

¹¹⁵ See W. PROSSER, *supra* note 25, § 1, at 2-3, §§ 111-17, 130.

¹¹⁶ See, e.g., *Johnson v. Sampson*, 167 Minn. 203, 208 N.W. 814 (1926).

¹¹⁷ W. PROSSER, *supra* note 25, § 56, at 343-48; RESTATEMENT (SECOND) OF TORTS § 323 & comment *e* at 139 (1965).

¹¹⁸ W. PROSSER, *supra* note 25, § 56, at 346.

¹¹⁹ 350 U.S. 61 (1955); *accord*, *Ingham v. Eastern Air Lines, Inc.*, 373 F.2d 227 (2d Cir.), *cert. denied*, 389 U.S. 931 (1967); *Armiger v. United States*, 339 F.2d 625 (Ct. Cl. 1964).

Indian Towing Co. also supports the contention that a plaintiff can recover for the denial of a benefit which he would have enjoyed but for the defendant's negligence. See text accompanying notes 127-36 *infra*. See also *Sioux Tribe v. United States*, 84 Ct. Cl. 16 (1936), *cert. denied*, 302 U.S. 740 (1937).

¹²⁰ *Morgan v. County of Yuba*, 230 Cal. App. 2d 938, 41 Cal. Rptr. 508 (Dist. Ct. App. 1964).

¹²¹ *Connelly v. State*, 3 Cal. App. 3d 744, 84 Cal. Rptr. 257 (Dist. Ct. App. 1970).

¹²² The applicability of the cases cited in notes 113-16 *supra* may be qualified by the

A plaintiff in an educational malpractice suit, however, will probably have to deal with a line of cases headed by *H. R. Moch Co. v. Rensselaer Water Co.*¹²³ In *Moch*, a plaintiff was denied recovery against a water company, under contract with the city to provide water, which negligently failed to provide adequate water to extinguish a fire before it reached and destroyed the plaintiff's warehouse. The court held, *inter alia*, that the suit was not maintainable as an action for a common law tort.¹²⁴ Although acknowledging that one who undertakes to act, even gratuitously, has a duty to act non-negligently, Judge Cardozo wrote,

If conduct has gone forward to such a stage that inaction would commonly result, not negatively merely in withholding a benefit, but positively or actively in working an injury, there exists a relation out of which arises a duty to go forward. . . . The query always is whether the putative wrongdoer has advanced to such a point as to have launched a force or instrument of harm, or has stopped where inaction is at most a refusal to become an instrument for good.¹²⁵

Cardozo characterized the failure to furnish an adequate supply of water as a denial of a benefit not the commission of a wrong.¹²⁶

Moch could be troublesome for a plaintiff in an educational malpractice case; it has been argued that the failure of a student to learn because of teacher negligence or intentional misconduct is not an injury cognizable in tort—that it is not an injury at all, but rather the loss of an expectancy or failure to receive a benefit.¹²⁷ In other kinds of cases, however, plaintiffs have recovered in tort for a variety of injuries which might be called lost expectancies or benefits. Legal malpractice cases, for example, have allowed plaintiffs to recover for benefits that they probably would have received under wills or from lawsuits but for the negligence of a lawyer.¹²⁸ Plaintiffs have also been recompensed

governmental immunity doctrines of the particular jurisdiction. Text accompanying notes 70-75 *supra*.

¹²³ 247 N.Y. 160, 159 N.E. 896 (1928); see *Stang v. City of Mill Valley*, 38 Cal. 2d 486, 240 P.2d 980 (1952); *Reimann v. Monmouth Consol. Water Co.*, 9 N.J. 134, 87 A.2d 325 (1952).

¹²⁴ 247 N.Y. at 167, 159 N.E. at 898.

¹²⁵ *Id.* at 167-68, 159 N.E. at 898.

¹²⁶ *Id.* at 169, 159 N.E. at 899.

¹²⁷ Defendants' Demurrer, *supra* note 47, at 44-46.

¹²⁸ See, e.g., *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961),

for tortious interference with the expectation of business profits.¹²⁹ The *Restatement of Torts* explains that "[w]here a person can prove that but for the tortious interference of another, he would have received a gift or a specific profit from a transaction, he is entitled to full damages for the loss which has thus been caused to him"¹³⁰ Recovery usually has been denied, according to Prosser, in cases in which there was no sufficient degree of certainty that the anticipated benefit would have been received, and such cases do not deny the existence of tort liability.¹³¹ Courts have allowed recovery where the receipt of the benefits was not certain but only highly probable. Furthermore, it has been argued that plaintiffs should be allowed to recover for the lost chance of receiving a benefit, the degree of certainty being relevant only to valuation of the loss.¹³²

Plaintiffs are also likely to recover for benefits denied because of the negligence of the person who seeks to bestow the benefit. For example, a rescuer who abandons or negligently performs a rescue is liable for resulting injury.¹³³ Indeed, Prosser asserts that recovery for a denied benefit is highly probable even in the absence of evidence that the defendant's action deprived the plaintiff of assistance from someone else:

It seems very unlikely that any court will ever hold that one who has begun to pull a drowning man out of the river after he has caught hold of the rope is free, without good reason, to abandon the attempt, walk away and let him drown, merely because he was already in extremis before the effort was begun.¹³⁴

The plaintiff's reliance and forbearance from seeking other services significantly strengthen an attempt to recover for

cert. denied, 368 U.S. 987 (1962); W. PROSSER, *supra* note 25, § 130, at 949-54; Wade, *supra* note 52, at 234 n.19.

¹²⁹ See W. PROSSER, *supra* note 25, § 130, at 950.

¹³⁰ RESTATEMENT OF TORTS § 912, comment *f* at 584 (1939). See also *Kely v. Price*, 27 Cal. App. 3d 209, 103 Cal. Rptr. 531 (Dist. Ct. App. 1972). But see *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928).

¹³¹ W. PROSSER, *supra* note 25, § 130, at 950-51.

¹³² *Id.* 951 & n.75. In *Sioux Tribe v. United States*, 84 Ct. Cl. 16 (1936), *cert. denied*, 302 U.S. 740 (1937), the court recognized that Indian children who had been denied educational benefits, which the Government should have provided under the terms of a treaty, had suffered a substantial loss. Yet the court denied recovery because the monetary value of the loss could not be calculated with sufficient certainty and exactitude.

¹³³ See W. PROSSER, *supra* note 25, § 56, at 343-44; RESTATEMENT (SECOND) OF TORTS § 324 A (1965).

¹³⁴ W. PROSSER, *supra* note 25, § 56, at 348.

the denial of benefits.¹³⁵ Thus, it seems that the strongest case would be, for example, one in which the plaintiff's parents were considering sending him or her to a private school, but, after receiving assurances from the principal, school officials, and teachers that instruction in the public school would be competent, decided to send their child to the public school. As a result of negligent instruction, the student failed to attain as high an educational level as he would have attained in a non-negligently taught class.¹³⁶ Characterizing the student's failure to learn as a lost benefit or expectation would not seem, at least under these circumstances, to preclude recovery.

Because the viability of the *Moch* distinction between denial of a benefit and commission of a wrong in tort actions is considerably undermined by the foregoing considerations and precedents, *Moch* is not followed in all jurisdictions. In 1964, the Supreme Court of Pennsylvania held that a complaint was sufficient in alleging that the plaintiff's house burned down because the water company, under contract with the city to provide water and maintain fire hydrants, had been negligent in maintaining the hydrant system.¹³⁷ The Pennsylvania court wrote of *Moch*,

Once Justice Cardozo recognized that the defendant was guilty of a "negligent omission," he admitted that the defendant had committed a breach of duty since negligence is defined in law as a breach of duty. If there was no breach of duty on the part of the defendant, its conduct could be not characterized as a negligent omission, but would be merely an omission that did not amount to negligence.¹³⁸

Even jurisdictions that follow *Moch* may not in fact be doing so in such a way as to impede school/teacher liability. In *Reimann v. Monmouth Consolidated Water Co.*,¹³⁹ the Supreme Court of New Jersey followed the *Moch* rule enunciating a policy basis, however, which suggests that the rule should not bar a suit for a student's failure to learn because of teacher negligence or incompetence. The court suggested that the availability of fire in-

¹³⁵ *Id.* 343-48.

¹³⁶ This also might be argued under a contract theory. See notes 181-207 *infra* & accompanying text.

¹³⁷ *Doyle v. South Pittsburgh Water Co.*, 414 Pa. 199, 199 A.2d 875 (1964). See also *Evans v. Otis Elevator Co.*, 403 Pa. 13, 168 A.2d 573 (1961).

¹³⁸ *Doyle v. South Pittsburgh Water Co.*, 414 Pa. 199, 214, 199 A.2d 875, 882 (1964).

¹³⁹ 9 N.J. 134, 87 A.2d 325 (1952).

insurance supports placing the loss on the property owner rather than the water company.¹⁴⁰ Students, however, cannot purchase insurance against their failure to learn. Indeed, the availability of liability insurance for teachers and school districts and the probable infrequency of educational malpractice suits undercut one of the primary policy reasons for denying liability in *Moch*—the fear of imposing a potentially limitless burden on suppliers of important public services.¹⁴¹

The duty arising from the control of the conduct of others provides another basis for the liability of school districts and officials for the educational harms caused by teachers who negligently or intentionally¹⁴² fail to meet minimum professional standards. According to the *Restatement (Second) of Torts*,

One who is required by law to take or who voluntarily takes the custody of another under circumstances such as to . . . subject him to association with persons likely to harm him, is under a duty to exercise reasonable care so to control the conduct of third persons as to prevent them from intentionally harming the other or so conducting themselves as to create an unreasonable risk of harm to him, if the actor

(a) knows or has reason to know that he has the ability to control the conduct of the third persons, and

(b) knows or should know of the necessity and opportunity for exercising such control.¹⁴³

These principles suggest that school officials should be liable if they subject students to instruction by teachers whom they knew or should have known were incompetent.¹⁴⁴

Statutorily imposed obligations may also be used to establish the duty necessary for recovery on a negligence theory.¹⁴⁵ In fact, in cases where tort liability is based on a statutory violation, the courts may be more willing to allow non-traditional damage claims than in common law tort actions. For example, section 815.6 of the *California Government Code* provides:

¹⁴⁰ *Id.* at 139, 87 A.2d at 327.

¹⁴¹ *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 165-66, 159 N.E. 896, 897-98 (1928); *see generally* text accompanying notes 43-50, 65-68 *supra*.

¹⁴² Text accompanying notes 164-69 *infra*.

¹⁴³ *RESTATEMENT (SECOND) OF TORTS* § 320 (1965); *accord*, W. PROSSER, *supra* note 25, § 56, at 349-50.

¹⁴⁴ As will be explained, these principles should also apply where a school official knew or should have known that a teacher would intentionally fail to teach according to minimum professional standards, *e.g.*, because of racial bias. Notes 164-69 *infra* & accompanying text.

¹⁴⁵ *See generally* Sax & Hiestand, *supra* note 40, at 914 & n.180.

Where a public entity is under a mandatory duty imposed by an enactment that is designed to protect against the risk of a particular kind of injury, the public entity is liable for an injury of that kind proximately caused by its failure to discharge the duty unless the public entity establishes that it exercised reasonable diligence to discharge the duty.¹⁴⁶

The California supreme court ruled in *Ramos v. County of Madera*¹⁴⁷ that a county welfare department could be liable under section 815.6 for coercing minors to work under threat of losing the benefits of Aid to Families with Dependent Children,¹⁴⁸ in violation of various regulations and statutes. In *Bradford v. State*,¹⁴⁹ that court held that the state could be liable under section 815.6 for negligent failure to record the dismissal of criminal charges against an individual as required by statute.

The plaintiff in *Doe v. San Francisco Unified School District*¹⁵⁰ invoked educational statutes to support the imposition of tort liability for negligent teaching under section 815.6.¹⁵¹ The various statutory provisions prescribe duties designed to protect students from the risk of not learning, and the plaintiff alleged that the defendants' failure to perform these duties resulted in the plaintiff's failure to learn. For example, plaintiff alleged violation of section 8573 of the *California Education Code*, which provides that "[n]o pupil shall receive a diploma of graduation from grade 12 who has not completed the course of study and met the standards of proficiency prescribed by the governing board."¹⁵² The defendants allegedly violated other statutory duties to keep parents accurately informed about the educational progress of their children,¹⁵³ to provide a course of study designed to fit the needs of the pupils for whom the course of study was prescribed,¹⁵⁴ to evaluate and revise the school district's educa-

¹⁴⁶ CAL. GOV'T CODE § 815.6 (West 1966).

¹⁴⁷ 4 Cal. 3d 685, 484 P.2d 93, 94 Cal. Rptr. 421 (1971). See also *Elton v. County of Orange*, 3 Cal. App. 3d 1053, 84 Cal. Rptr. 27 (Dist. Ct. App. 1970).

¹⁴⁸ 42 U.S.C. §§ 601-10 (1970), as amended, (Supp. III, 1973).

¹⁴⁹ 36 Cal. App. 3d 16, 111 Cal. Rptr. 852 (Dist. Ct. App. 1973).

¹⁵⁰ No. 653-312 (Cal. Super. Ct., Sept. 6, 1974), appeal docketed, Civil No. 36851, 1st Dist. Ct. App., Apr. 28, 1975).

¹⁵¹ Plaintiff's Memorandum, *supra* note 6, at 21-23.

¹⁵² CAL. EDUC. CODE § 8573 (West 1975); Plaintiff's Memorandum, *supra* note 6, at 21 n.12.

¹⁵³ CAL. EDUC. CODE § 10759 (West 1975); Plaintiff's Memorandum, *supra* note 6, at 21 n.11.

¹⁵⁴ CAL. EDUC. CODE § 8505 (West 1975); Plaintiff's Memorandum, *supra* note 6, at 22 n.14.

tional program¹⁵⁵ and to examine, at least once a term, the management, needs, and conditions of the schools.¹⁵⁶

The failure of students to learn is clearly the risk against which the above-described educational statutes were enacted to protect. Like the statutes involved in *Ramos*¹⁵⁷ and *Bradford*,¹⁵⁸ the educational statutes allegedly violated in *Doe* are designed to benefit a special segment of the community, school-age children, rather than the general public—a prerequisite to recovery under this theory.¹⁵⁹ The requirements of section 815.6, therefore, would appear to have been met in *Doe*, subject, of course, to problems of proof.¹⁶⁰

The common law also recognizes the principle that negligent failure to perform a statutory duty gives rise to a cause of action in tort to recover for injuries caused by the negligence, if the person injured was a member of the class for whose benefit the statute was enacted and the injury was of a type which the statute was enacted to prevent.¹⁶¹ According to one court, "The disregard of the command of a statute is a wrongful act and a tort."¹⁶²

The *Restatement (Second) of Torts* maintains that although a court will not find that a statutory provision designed to secure a benefit to the general public creates a duty of reasonable care, an individual may maintain an action in tort on the basis of the statutory violation if he suffers a harm distinct from that suf-

¹⁵⁵ CAL. EDUC. CODE § 8002 (West 1975); Plaintiff's Memorandum, *supra* note 6, at 22 n.13.

¹⁵⁶ CAL. EDUC. CODE § 1053 (West 1975); Plaintiff's Memorandum, *supra* note 6, at 22 n.13.

The plaintiff in *Doe* also suggested that compulsory attendance statutes give rise to a "duty" by the school to provide minimally competent instruction, the violation of which gives rise to tort liability. *E.g.*, CAL. EDUC. CODE § 12154 (West 1975); MASS. ANN. LAWS ch. 76, § 1 (Supp. 1975). See Plaintiff's Memorandum, *supra* note 6; *cf.* *Serna v. Portales Municipal Schools*, 351 F. Supp. 1279 (D.N.M. 1972), *aff'd*, 499 F.2d 1147 (10th Cir. 1974); *Mills v. Board of Education*, 348 F. Supp. 866 (D.D.C. 1972). The plaintiff further suggested that if there is no such "duty," the compulsory education statutes may be unconstitutional. Plaintiff's Memorandum, *supra* note 6, at 17; *cf.* *Wyatt v. Stickney*, 325 F. Supp. 781 (M.D. Ala. 1971). Other arguments made by plaintiff based on a constitutional right (state and federal) to education are beyond the scope of this Comment. Plaintiff's Memorandum, *supra* note 6, at 37-39; see Ratner, *supra* note 12.

¹⁵⁷ 4 Cal. 3d 685, 484 P.2d 93, 94 Cal. Rptr. 421 (1971).

¹⁵⁸ 36 Cal. App. 3d 16, 111 Cal. Rptr. 852 (Dist. Ct. App. 1973).

¹⁵⁹ See *Stang v. City of Mill Valley*, 38 Cal. 2d 486, 240 P.2d 980 (1952); RESTATEMENT (SECOND) OF TORTS §§ 286, 288, comment c at 31 (1965).

¹⁶⁰ Text accompanying notes 219-55 *infra*.

¹⁶¹ See, *e.g.*, *Routh v. Quinn*, 20 Cal. 2d 488, 127 P.2d 1 (1942); RESTATEMENT (SECOND) OF TORTS §§ 288 B, 286.

¹⁶² *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, 513 (E.D. Pa. 1946).

fered by the rest of the community.¹⁶³ The harm suffered by the students of an incompetent teacher is obviously of a different type from that suffered by the general community.

b. *Intentional Tort*

Under some circumstances, a student may be able to recover for failure to learn under an intentional tort theory, akin to intentional infliction of mental distress.¹⁶⁴ Suppose, for example, that a high school English teacher, with preconceptions about the limited educability of his ghetto students, decides not to teach them literature but instead distributes comic books or third grade reading matter. Suppose that a high school science teacher with a similar appraisal of his students decides that there is no reason for them to learn chemistry and spends the term trying to inculcate passivity, deference, and good behavior. Depending on the teacher's state of mind, this behavior might be characterized as an intentional tort.¹⁶⁵ Although intentional denial of an educational benefit is beyond the present boundaries of tort law, it is a harm at least as demonstrable and as deserving of redress as intentionally inflicted mental distress. Because the law of intentional torts is probably more elastic in the recognition of new kinds of injuries than is the law of negligence,¹⁶⁶ an intentional tort theory provides a promising legal framework for a suit of this type, where the facts permit its use.

A plaintiff also might present a case of this type as an intentional infliction of mental distress. If the claim is, for example, that the teacher intentionally humiliated a student, the case is not especially difficult¹⁶⁷ but is clearly different from the kind of suits contemplated by this Comment. If it is argued that mental distress resulted from the intentional denial of educational

¹⁶³ RESTATEMENT (SECOND) OF TORTS § 288, comment c at 31 (1965); see *Stang v. City of Mill Valley*, 38 Cal. 2d 486, 240 P.2d 980 (1952); RESTATEMENT (SECOND) OF TORTS §§ 286, 288 (1965).

¹⁶⁴ See *Johnson v. Sampson*, 167 Minn. 203, 208 N.W. 814 (1926); W. PROSSER, *supra* note 25, § 12, at 49-62.

¹⁶⁵ The intent with which tort liability is concerned is not necessarily a hostile intent, or a desire to do any harm. Rather it is an intent to bring about a result which will invade the interests of another in a way that the law will not sanction. The defendant may be liable although he has meant nothing more than a good-natured practical joke, or has honestly believed that he would not injure the plaintiff, or even where he was seeking the plaintiff's own good. W. PROSSER, *supra* note 25, § 12, at 31.

¹⁶⁶ "In this respect, the law is clearly in a process of growth, the ultimate limits of which cannot as yet be determined." *Id.* 50.

¹⁶⁷ See *Johnson v. Sampson*, 167 Minn. 203, 208 N.W. 814 (1926).

benefits,¹⁶⁸ it is unclear whether this claim puts the case within the existing case law. Representing the denial of educational benefits as not merely analogous to but in itself constituting the intentional infliction of mental distress, however, may make the argument seem less radical and more familiar and persuasive to a court.

c. *Misrepresentation*

In some situations, a student-plaintiff may be able to seek recovery on theories of negligent or intentional misrepresentation. Assume that a teacher issues a satisfactory progress report about a student who the teacher knows or should know is not progressing satisfactorily. (Standardized test scores, for example, indicate that the student is reading far below grade level.) The student's parents seek confirmation of the report from the teacher, explaining that they will obtain remedial instruction if their child is not making satisfactory progress. The teacher, to dissuade the parents from speaking to his or her superior regarding such instruction, reassures them of the student's satisfactory performance; as a result of the teacher's reports, the student never receives remedial instruction.

This factual situation seems to satisfy Prosser's enumeration of the elements of a cause of action in deceit:

1. A false representation made by the defendant. . . .
2. Knowledge or belief on the part of the defendant that the representation is false—or, what is regarded as equivalent, that he has not a sufficient basis of information to make it. . . .
3. An intention to induce the plaintiff to act or to refrain from action in reliance upon the misrepresentation.
4. Justifiable reliance upon the representation on the part of the plaintiff, in taking action or refraining from it.
5. Damage to the plaintiff, resulting from such reliance.¹⁶⁹

In some jurisdictions, a negligent misrepresentation also may give rise to tort liability. A representation made without

¹⁶⁸ Complaint, *supra* note 4, at 8-9.

¹⁶⁹ W. PROSSER, *supra* note 25, at 685-86 (footnotes omitted). Cf. *Connelly v. State*, 3 Cal. App. 3d 744, 84 Cal. Rptr. 257 (Dist. Ct. App. 1970).

knowledge of its falsehood is negligent if the defendant did not take reasonable care to ascertain its truth.¹⁷⁰ The necessary duty of reasonable care in ascertaining the truth¹⁷¹ can easily be found in the student-teacher relationship¹⁷² or in statutes requiring the teacher to give accurate evaluations of students' achievement.¹⁷³ The teacher's knowledge that the parent will reasonably rely on the representation should also be sufficient to establish a duty of reasonable care.¹⁷⁴ The requirement that the plaintiff's reliance and his actions based on that reliance be reasonable seem easily satisfied in this context.¹⁷⁵

Misrepresentations of opinion are generally not a basis for relief,¹⁷⁶ and it is debatable whether a student's progress report is a statement of fact or opinion. Even assuming that it is merely a teacher's opinion, however, there are exceptions to the general rule where special circumstances make it reasonable for the plaintiff to accept and act in reliance upon the statement: where reliance is justifiable, where the opinion implies that the defendant knows of no facts which would preclude the opinion and knows facts which justify it, or where the defendant holds himself out as having special knowledge of the matter which is not available to the plaintiff.¹⁷⁷ A student's progress report written by a teacher seems to fit all these exceptions.

Other situations which could give rise to a misrepresentation action include the following:

(1) Parents trying to decide whether to send their child to public or private school ask public school officials about the quality of the public schools. The school officials, who know or should know of the poor quality of the public schools, assure the parents that their school offers high quality education. The student, previously an outstanding performer, falls to a low level of achievement, as measured by standardized tests.¹⁷⁸ In the case of a similar representation by a private school, a claim of deceit or negligent misrepresentation might be raised to obtain rescission

¹⁷⁰ W. PROSSER, *supra* note 25, § 107, at 704.

¹⁷¹ *Id.* 706.

¹⁷² "[W]here the representation, although itself gratuitous, is made in the course of the defendant's business or professional relations, the duty is usually found." *Id.*

¹⁷³ *See, e.g.*, CAL. EDUC. CODE § 10759 (Supp. 1975).

¹⁷⁴ W. PROSSER, *supra* note 25, § 107, at 707.

¹⁷⁵ *See id.* § 108, at 714-20.

¹⁷⁶ *Id.* § 109, at 721.

¹⁷⁷ *Id.* 726-27.

¹⁷⁸ *See* text accompanying notes 219-55 *infra*.

of a contract or used as a defense in a suit by the school for tuition.¹⁷⁹

(2) Teachers and school officials who know or should know of the student's inferior academic ability urge him to switch from the vocational to the academic course of study, misrepresenting his abilities to him in order to correct an imbalance between the two programs. The student switches, performs poorly in the academic program, and leaves school without vocational skills and unqualified for a college education.

(3) The teacher negligently or intentionally misrepresents a student's progress, as a result of which the student is held back a year. The student sues for loss of a year's income.¹⁸⁰

2. Contract Theories

The law of contracts provides several lines of argument which might support a suit for failure to learn because of teacher negligence or incompetence.¹⁸¹ First, it might be argued that there are implied contracts between the teacher and the student and between the school district and the student. An implied term of the contracts is that the student will be given non-negligent instruction.¹⁸² The consideration for this promise is that the stu-

¹⁷⁹ See W. PROSSER, *supra* note 25, § 105, at 687-89; text accompanying notes 256-63 *infra*.

¹⁸⁰ See W. PROSSER, *supra* note 25, § 106, at 694-95. Misrepresentation is available to people other than the student and his parents. Assume that the school issues a diploma and recommendation, representing (expressly or impliedly) that the student possesses certain minimum educational skills. An employer relies on these representations and hires the student, who is illiterate and consequently untrainable. The student makes serious reading or counting errors which result in a loss to the employer. The employer might have a cause of action for misrepresentation. See *id.* For a discussion of the usefulness of misrepresentation theories in the private school context, see notes 256-63 *infra* & accompanying text.

¹⁸¹ Since American courts have extended tort liability for misfeasance to virtually every type of contract where defective performance may injure the promisee, a plaintiff may have the option to sue in tort, contract, or both. W. PROSSER, *supra* note 25, § 92, at 617 nn.47-56 & 65; see Wade, *supra* note 52, at 219 & n.13.

¹⁸² See *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied*, 368 U.S. 987 (1962), in which the court found that by accepting employment to give legal advice or services, a lawyer impliedly agrees to use such skill, prudence, and diligence as lawyers of ordinary skill and capacity commonly possess and exercise in the performance of professional tasks they undertake; Wade, *supra* note 52, at 218-19 n.11; *Professional Negligence*, *supra* note 51, at 679. See also *Arthur Murray, Inc. v. Parris*, 243 Ark. 441, 420 S.W.2d 518 (1967); *Stad v. Grace Downs Model & Air Career School*, 65 Misc. 2d 1095, 319 N.Y.S.2d 918 (Queens County Civ. Ct. 1971). It should be made clear that this is something distinct from a negligence action in tort, although Prosser points out that there will be liability in tort for misperformance of a contract whenever there would have been liability for gratuitous performance without a contract. W. PROSSER, *supra* note 25, § 92, at 617. The notion of non-negligent instruction is borrowed from the tort law to "measure" the promise to teach. It is arguable that by holding himself out as a

dent, in reliance on this implied promise, forbears seeking education elsewhere and attends school although, at least in the case of secondary school students, he could drop out.¹⁸³ An alternative formulation could be based on the doctrine of promissory estoppel.¹⁸⁴ It could be argued that the teacher's implied promise to teach non-negligently or the school district's implied promise to provide non-negligent teachers was made binding by the student's detrimental reliance on the promise.

A problem with this contractual theory is the requirement in some jurisdictions that consideration be "bargained for."¹⁸⁵ Even in such jurisdictions, however, this contract might stand since the student's attendance in reliance upon the implied promise of non-negligent instruction was within the contemplation of the parties. A second problem is the contention that the student's attendance cannot be consideration, because it is required by law¹⁸⁶ and the student could not have refused to attend.¹⁸⁷ Furthermore, compulsory attendance does not apply to students above a certain age; finding consideration in attendance by these students would not be subject to the above-stated objection. Even for students within the age of compulsory attendance, forbearance from seeking private instruction could be consideration for the promise of non-negligent instruction or, alternatively, might bring into operation the doctrine of promissory estoppel.¹⁸⁸ Of course a defendant could require a showing that plaintiff would or might have sought private education if not for the promise of non-negligent teaching. This possible requirement might have the anomalous effect of making this contract theory available only to relatively wealthy students who could have afforded private education.

Although the theory of contractual agreements between student and school district and between student and teacher is most plausible in the private school context where both the

teacher in certain school districts a teacher is implicitly promising a higher level of competence than mere non-negligence. Although this approach is distinct from a negligence theory of tort liability, the procedures outlined in this Comment for proving negligence, causation, and damages seem applicable to the various contract actions suggested in this section.

¹⁸³ See J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* §§ 53-56, 61 (1970).

¹⁸⁴ See *id.* §§ 99-111.

¹⁸⁵ *Id.* § 53, at 105.

¹⁸⁶ E.g., MASS. ANN. LAWS ch. 76, §§ 1,2 (Supp. 1975).

¹⁸⁷ See J. CALAMARI & J. PERILLO, *supra* note 183, § 60.

¹⁸⁸ If students are not given competent instruction compulsory attendance may also be a deprivation of liberty without due process of law in violation of the fourteenth amendment. See Ratner, *supra* note 12, at 18.

promise and the consideration are easily identifiable,¹⁸⁹ it is applicable in the public school context in certain situations. For example, assume that a family moves to a new town and the parents tell the public school principal that they are trying to decide whether to send their child to public or to private school. Perhaps they express particular concern about the reading program. After the principal and teachers assure the parents of the competence of the reading teachers, the parents decide to send their child to public school, where he is negligently taught. The contract approach would also be applicable where a high school student is negligently taught after being dissuaded, by his principal and teachers, from dropping out of school to get a job because he believes his teachers are incompetent.¹⁹⁰

There is another contract theory upon which a public school student might base a suit for his failure to learn because of teacher negligence. The plaintiff could argue that an implied term of the contract between the teacher and the school district is that the teacher will teach non-negligently.¹⁹¹ The student, as a third party beneficiary of the contract, should have a right to recover for its breach by the teacher.¹⁹²

Professors Calamari and Perillo assert that the test of whether a beneficiary of a contract has a right to enforce it is whether there is an "intent to benefit" the third party.¹⁹³ While a minority of courts have held that both parties must intend to benefit the third party, the majority believe that the promisee's intention is more important.¹⁹⁴ The *Restatement (Second) of Contracts* concludes that "intent to benefit" is ascertained by whether "[t]he beneficiary would be reasonable in relying on the promise as manifesting an intention to confer a right on him."¹⁹⁵ Many

¹⁸⁹ See *Arthur Murray, Inc. v. Parris*, 243 Ark. 441, 420 S.W.2d 518 (1967). See also *Stad v. Grace Downs Model & Air Career School*, 65 Misc. 2d 1095, 319 N.Y.S.2d 918 (Queens County Civ. Ct. 1971).

¹⁹⁰ The question of damages is discussed at text accompanying notes 19-31 *supra*.

¹⁹¹ See *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied*, 368 U.S. 987 (1962); *Professional Negligence*, *supra* note 51; notes 94-104 *supra* & accompanying text.

¹⁹² See, e.g., *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied*, 368 U.S. 987 (1962); *Gorrell v. Greensboro Water-Supply Co.*, 124 N.C. 328, 32 S.E. 720 (1899); J. CALAMARI & J. PERILLO, *supra* note 183, § 243; cf. *Lemon v. Bossier Parish School Bd.*, 240 F. Supp. 709 (W.D. La. 1965), *aff'd*, 370 F.2d 847 (5th Cir.), *cert. denied*, 388 U.S. 911 (1967); *Randall v. Sumter School Dist.*, 232 F. Supp. 786 (E.D.S.C. 1964), *modified*, 241 F. Supp. 787 (E.D.S.C. 1965). But see *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928).

¹⁹³ J. CALAMARI & J. PERILLO, *supra* note 183, § 244, at 380-81.

¹⁹⁴ *Id.* 380.

¹⁹⁵ RESTATEMENT (SECOND) OF CONTRACTS § 133, comment *d* at 288 (Tent. Drafts

cases have held that if performance runs to the third party, he will ordinarily be treated as an intended beneficiary with enforceable rights.¹⁹⁶ Under any of these approaches, a student is at least arguably a third party beneficiary with a right to enforce¹⁹⁷ the teacher's implied (or express) promise to the school district to teach non-negligently.¹⁹⁸

In some jurisdictions, the third-party beneficiary theory is hampered by the doctrine that where a municipal government contracts with a contractor for the benefit of the municipality's inhabitants, individual inhabitants generally do not have a right to enforce the contract.¹⁹⁹ Yet there are exceptions to this rule. If a contractor agrees to perform services which the municipality is under a legal duty to provide to specified individual members

Nos. 1-7, 1973); see J. CALAMARI & J. PERILLO, *supra* note 183, § 244, at 381. In some states the rights of third party beneficiaries are set forth in statutes.

¹⁹⁶ J. CALAMARI & J. PERILLO, *supra* note 183, § 244, at 381.

¹⁹⁷ In *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied*, 368 U.S. 987 (1962), the court recognized that it is essentially a matter of policy whether defendant (breaching promisor) will be liable to third party beneficiaries.

[T]he determination whether in a specific case the defendant will be held liable to a third person not in privity is a matter of policy and involves 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, and the policy of preventing future harm.

Id. at 588, 364 P.2d at 687, 15 Cal. Rptr. at 823. The court also emphasized that the plaintiff would be able to recover as a third party beneficiary under a contract theory, because the main purpose of the contract was to benefit third parties, and it was the clear intent of the promisee that the contract benefit these third parties. *Id.* at 589-90, 364 P.2d at 688, 15 Cal. Rptr. at 824.

¹⁹⁸ If the school district is not vicariously liable, which it might not be since the teacher's liability would be for breach of contract rather than for tortious acts or omissions, the liability would rest upon the teacher alone. This might jeopardize both the legal and practical chances of recovering substantial monetary damages at the present time. Text accompanying note 91 *supra*. If, however, a precedent of liability were set, it is likely that teachers would soon carry malpractice insurance as a matter of course, see notes 44-46 *supra* & accompanying text, and recovery of money damages for remedial instruction might become a practical possibility. Even though money recovery seems improbable, the student might, under some circumstances, demand specific performance of the promise of non-negligent teaching. See *Lemon v. Bossier Parish School Bd.*, 240 F. Supp. 709 (W.D. La. 1965), *aff'd*, 370 F.2d 847 (5th Cir.), *cert. denied*, 388 U.S. 911 (1967); *Randall v. Sumter School Dist.*, 232 F. Supp. 786 (E.D.S.C. 1964), *modified*, 241 F. Supp. 787 (E.D.S.C. 1965). For example, if the negligence of the teacher consisted of failure to follow accepted teaching techniques, the court might order the teacher to adopt accepted methods, e.g., order a reading teacher who failed to give out books to do so. Also, the student might be able to enforce a contractual term allowing the school board to dismiss the teacher "for cause."

¹⁹⁹ See *H.R. Moch Co. v. Rensselaer Water Co.*, 247 N.Y. 160, 159 N.E. 896 (1928); J. CALAMARI & J. PERILLO, *supra* note 183, § 247, at 387. But see, e.g., *Gorrell v. Greensboro Water-Supply Co.*, 124 N.C. 328, 32 S.E. 720 (1899).

of the public, a contractor's improper performance of the contract resulting in injury to these individuals will give them a cause of action for breach.²⁰⁰ It has also been held that contracts into which a governmental unit enters, not just to protect the public from harm, but to secure advantages to the public, create rights enforceable by members of the public.²⁰¹ Because students are an identifiable class of persons for whose benefit the teacher's promise of non-negligent instruction is ostensibly made, and because the municipality is probably under a legal duty to provide education the students should fall within the exceptions to the non-enforcement rule.

A contract approach in a suit for failure to learn because of teacher negligence or incompetence may have several advantages over a tort approach. First, governmental immunities, which may bar recovery in tort, might not preclude a successful contract action.²⁰² Second, courts may be more willing to allow recovery for loss of an expectancy or benefit in contract than in tort.²⁰³ In *Doe v. San Francisco Unified School District*,²⁰⁴ the defendant suggested that recovery for the injuries alleged in that suit would be possible in a contract action, although he denied the existence of a contract upon which to base an action.²⁰⁵ Third, defenses such as contributory negligence or assumption of risk may bar recovery in tort but not in contract. Finally, actions in tort and actions in contract may be governed by different statutes of limitations, the statutes generally being shorter for tort actions.²⁰⁶

On the other hand, recovery under some theories of contract damages may be limited to the damages tacitly agreed upon by the parties—perhaps payment for remedial instruction to confer the benefit denied by the teacher—while recovery in tort may extend to a wider range of damages, for example, loss of future income.²⁰⁷ Furthermore, the tort law is more flexible and more hospitable to novel lawsuits than the law of contracts. Ul-

²⁰⁰ J. CALAMARI & J. PERILLO, *supra* note 183, § 247, at 388.

²⁰¹ *Id.* 389 & nn.64-68.

²⁰² W. PROSSER, *supra* note 25, § 92, at 619; *see* notes 70-75 *supra* & accompanying text.

²⁰³ *See* W. PROSSER, *supra* note 25, § 92, at 619. *But see* *Lucas v. Hamm*, 56 Cal. 2d 583, 364 P.2d 685, 15 Cal. Rptr. 821 (1961), *cert. denied*, 368 U.S. 987 (1962); W. PROSSER, *supra* note 24, § 93, at 623.

²⁰⁴ No. 653-312 (Cal. Super. Ct., Sept. 6, 1974), *appeal docketed*, Civil No. 36851, 1st Dist. Ct. App., Apr. 28, 1975.

²⁰⁵ Defendants' Demurrer, *supra* note 47, at 4.

²⁰⁶ W. PROSSER, *supra* note 25, § 92, at 618.

²⁰⁷ *Id.* 619.

timately, the desirability of proceeding in tort, contract, or both, will depend on the circumstances of the particular case.

3. Mandamus

If the court refuses to recognize a tort or contract theory, a plaintiff might seek relief by petition for mandamus. If this approach is available at all, however, it could only be used in a very limited number of situations.

A writ of mandamus is a court order compelling a person to perform a duty imposed on him by law.²⁰⁸ Mandamus is most often used to compel an official to take action of a non-discretionary or "ministerial" nature.²⁰⁹ Although it can also be used to compel an official to exercise his discretion,²¹⁰ it will not compel him to exercise that discretion in a particular manner, unless the official's prior discretionary action was arbitrary or unreasonable.²¹¹ Other requirements for use of mandamus (depending on the jurisdiction) are a clear legal right in the plaintiff²¹² or a clearly prescribed official duty in the performance of which the plaintiff has an interest,²¹³ and the inadequacy of other legal remedies.²¹⁴

In education cases, mandamus has been used to compel school officials to perform ministerial duties²¹⁵ and exercise discretion.²¹⁶ In some cases courts have reviewed discretionary actions of school officials under an "arbitrary and unreasonable" standard.²¹⁷

Suppose that a state statute clearly directs school officials to hire teachers with certain qualifications, and an official hires a teacher without those qualifications. Mandamus might be used to enjoin the official from rehiring that teacher. The remedy might also be available to halt the practice of graduating students who fail to obtain the minimum level of reading competence required

²⁰⁸ See, e.g., *Leonard v. School Comm.*, 349 Mass. 704, 212 N.E.2d 468 (1965).

²⁰⁹ See, e.g., *Shirey v. City Bd. of Educ.*, 266 Ala. 185, 94 So. 2d 758 (1957).

²¹⁰ E.g., *Martin v. Garnet Valley School Dist.*, 441 Pa. 502, 272 A.2d 913 (1971); *State ex rel. Knudsen v. Board of Educ.*, 43 Wis. 2d 58, 168 N.W.2d 295 (1969).

²¹¹ E.g., *Gustafson v. Wittersfield Twp. High School*, 319 Ill. App. 255, 49 N.E.2d 311 (1943); *Martin v. Garnet Valley School Dist.*, 441 Pa. 502, 272 A.2d 913 (1971).

²¹² See, e.g., *Martin v. Garnet Valley School Dist.*, 441 Pa. 502, 272 A.2d 913 (1971); *Wenders v. White Mills Indep. School Dist.*, 171 Pa. Super. 39, 90 A.2d 318 (1952).

²¹³ See, e.g., *Leonard v. School Comm.*, 349 Mass. 704, 212 N.E.2d 468 (1965).

²¹⁴ E.g., *Shirey v. City Bd. of Educ.*, 266 Ala. 185, 94 So. 2d 758 (1957).

²¹⁵ *Id.*

²¹⁶ See, e.g., cases cited note 210 *supra*.

²¹⁷ E.g., *State ex rel. Baker v. Stevenson*, 27 Ohio Op. 2d 223, 189 N.E.2d 181 (C.P. 1962); *Leonard v. School Comm.*, 349 Mass. 704, 212 N.E.2d 468 (1965).

by statute for graduation.²¹⁸

Notwithstanding the usefulness of mandamus in these limited cases, it is unlikely that a court in a mandamus action would order dismissal of a teacher deemed competent by school officials, or would compel officials to take a particular remedial action. Nor would mandamus provide a route for requiring compensation for lost earnings. The limited extent to which the remedy can be used to challenge official policies and decisions of a discretionary character severely impairs its efficacy; it does not serve the function of the tort or contract cause of action.

D. *Problems of Proof*

1. Proof of Causation of Harm

The first question likely to be provoked by the suggestion of a cause of action for the failure of students to learn because of teacher incompetence is that of proof: How can a plaintiff prove that a teacher's negligence caused his failure to learn? A method of proof that relies on inferences drawn from circumstantial evidence is essential in this type of case.²¹⁹ If an individual student alleges that his failure to learn was due to the incompetence or negligence of his teacher[s], it perhaps seems impossible to prove that the substandard result was not the consequence of the student's own lack of intelligence, aptitude, diligence, attitude, ambition, or general educability.²²⁰ This obstacle to plaintiff's proof of causation can be avoided if the plaintiff undertakes a comparative method of proof.

a. *The Comparative Method*

Under this method of proof, the plaintiff establishes causation by proving that a class of which he is a member performed significantly worse than did classes identical in all essential re-

²¹⁸ See, e.g., CAL. EDUC. CODE §§ 8573-75 (West 1975).

²¹⁹ See *Lubell v. Nyquist*, 31 App. Div. 2d 569, 294 N.Y.S.2d 961 (1968), *appeal denied*, 23 N.Y. 645, 298 N.Y.S.2d 1027 (1969); RESTATEMENT (SECOND) OF TORTS § 328 D & comment b at 157-58 (1965); cf. *Fowler v. Seaton*, 61 Cal. 2d 681, 394 P.2d 697, 39 Cal. Rptr. 881 (1964). But see *Wade*, *supra* note 52, at 228, stating, "There is no indication of application of . . . res ipsa loquitur to attorney-negligence cases."

²²⁰ Of course, a student with a high intelligence, documented diligence, and a record of achievement in other courses might be able to establish that his failure to achieve high standardized test scores in a subject was due to the negligence or incompetence of his teacher, since he could eliminate the other possible causes. For less "ideal" students, however, this approach would not be available.

spects except that they were not taught by the defendant teacher. The class of which the plaintiff is a member ("plaintiff class") can consist of the students of a particular teacher in one year or over a number of years, or students who have completed an entire reading or math program in one year or over a number of years. The causal effect of a teacher on the educational achievement of his or her students can be isolated by comparing the performance of the plaintiff class with the performances, in the same subject, of students in the same or similar communities, in schools of the same socio-economic composition, similar size and per-student funding, in classes of similar size, with the same IQ groupings, or other characteristics identified by experts as determinants of educational success (comparison classes).²²¹ By holding constant these factors, which could have determined the educational success of the student class, the effect of the teacher on student performance can be proven.²²² The plaintiff would introduce expert testimony that the comparisons have, in fact, held constant all the factors, other than teacher quality, relevant to the performance of a class of students.²²³ Class performance could be measured by the average of the differences between scores on achievement tests taken by each student upon entering and leaving the teacher's class.²²⁴

Suppose that at the beginning of the school year students of teacher *A* read, on the average, at the third-grade level. At the end of the school year they read on the fourth-grade level. Students of teacher *B*, who have the same "essential characteristics" (enumerated above) as the students of teacher *A*, begin the year

²²¹ See MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 202, at 485 (2d ed. E. Cleary 1972) [hereinafter cited as MCCORMICK]; C. JENCKS, *supra* note 11.

²²² See MCCORMICK, *supra* note 221, § 202 at 485; C. JENCKS, *supra* note 11. Various authorities support the use of circumstantial evidence to prove both cause in fact and negligence. In *Lubell v. Nyquist*, 31 App. Div. 2d 569, 294 N.Y.S. 2d 961 (1968), *appeal denied*, 23 N.Y. 645, 298 N.Y.S.2d 1027 (1969), a teacher's qualification for license as chairman of a high school English department was determined by a "teaching test" in which the teacher's performance was apparently judged by the performance of the students on achievement tests. This test assumes that the students' test performance was, to a measurable extent, "caused" by the conduct of the teacher. *Res ipsa loquitur* has also been used to establish negligence and cause in fact in medical malpractice cases. *E.g.*, *Ybarra v. Spangard*, 25 Cal. 2d 486, 154 P.2d 687 (1944). Moreover, according to the *Restatement (Second) of Torts*, "[n]egligence and causation, like other facts, may . . . be proved by circumstantial evidence." RESTATEMENT (SECOND) OF TORTS § 328 D, comment *b* at 157 (1965).

²²³ See RESTATEMENT (SECOND) OF TORTS § 328 D, comment *d* at 152-59 (1965). See generally, C. JENCKS, *supra* note 11.

²²⁴ In a first-year course there would, of course, be no entering test scores. In that situation, however, we could hold constant performance in related subjects and assume a zero entering score for all classes.

reading on the third-grade level and finish the year at the 3.2 grade level. Because the only relevant factor that varied between the groups was the teacher, it can be argued that the performance differential was due to differential teacher input.

The probative value of the comparison might be increased by a presentation of the performances of the defendant teacher's classes over a number of years. A showing that the performance of the plaintiff class is not significantly different from that of all of the defendant's classes strengthens the inference that the performance differential between the plaintiff class and the comparison class is attributable to the teacher, rather than to the plaintiff class's abnormality.²²⁵

b. *Objections to the Comparative Method*

Although the intergroup comparison permits the inference that the test score differences are due to different teacher input,²²⁶ the defendant may raise several objections to plaintiff's presentation. The defendant may argue the comparison has failed to hold constant a factor, other than teacher performance, which could have produced the differential test results. For example, the plaintiff class may have been abnormal for a group with the essential characteristics held constant in the comparison. Absent a showing that the defendant's classes have performed uniformly poorly over a multi-year period,²²⁷ the showing of comparatively poor test performance may indicate either that the inferior group was abnormal—perhaps the class had an unusually high number of troublemakers—or that the teacher was incompetent.

The possibility that the test score differentials were caused by something other than different teacher inputs, however, should not eliminate the availability of the comparative technique to the plaintiff in making a *prima facie* case. In view of the obvious difficulty of identifying comparison classes with all possible characteristics identical to those of the plaintiff class, once

²²⁵ While a consistently inferior showing by defendant's students strengthens the claim that the teacher was the cause, such a showing may not always be essential or possible, as in the case of a first-year teacher or a previously competent teacher who becomes senile.

Although the method of proof outlined above would lend itself most readily to a class action suit, it is available to the individual plaintiff. For a discussion of the advantages and disadvantages of a class action suit, see note 23 *supra*.

²²⁶ See RESTATEMENT (SECOND) OF TORTS § 328 D, comment *n* at 165-66 (1965). See generally MCCORMICK, *supra* note 221, §§ 336-47.

²²⁷ Such a showing would be impossible in the cases of the incompetent first-year teacher and the elderly teacher who was competent until the present school year.

the classes are shown to share the characteristics enumerated above, they should be presumed to be comparable in all other respects. The defendant should be permitted to rebut this presumption with evidence of the abnormality of the plaintiff class, for example, through the testimony of the principal that this was the worst behaved class he has seen in twenty years of school administration.²²⁸ It would then be for the jury to decide whether it was the teacher or the troublemakers who made the difference.

Although the defendant might point out that some studies suggest that teacher quality does not have a very great effect on achievement test scores,²²⁹ and that some of the other factors previously mentioned are more significant determinants of test-measured success, this technique would allow comparative measurement of whatever influence a teacher does have on test scores. The disagreement among authorities regarding the degree of correlation between test scores and cognitive skills, teacher quality, or economic success²³⁰ should not be crucial. The judge or jury will simply have to choose among conflicting expert opinions. As in antitrust cases, where the courts must rely on highly imperfect and debatable methods of proving cause and damages,²³¹ perhaps test scores, though imperfect, are the best available indicators of how much students have learned under different conditions. Yet to the extent that courts remain unconvinced that poor test scores indicate the failure of students to learn fundamental skills, it is clear that a suit of this type, proven with the methods herein outlined, will not have a great likelihood of success.

The comparative technique might also be criticized for suggesting that an entire class was "harmed," while, in fact, the top or bottom ten percent may have performed better than they would have performed in comparison classes. For example, the teacher may have taught to the best or worst students and ignored the rest. Under the negligence standard developed in this Comment,²³² however, it is questionable whether a teacher would be deemed negligent if a significant proportion of his or her students performed outstandingly. Even if some students did better with this teacher than they would have done in the

²²⁸ See *Lubell v. Nyquist*, 31 App. Div. 2d 569, 294 N.Y.S.2d 961 (1968), *appeal denied*, 23 N.Y. 645, 298 N.Y.S.2d 1027 (1969).

²²⁹ E.g., C. JENCKS, *supra* note 11.

²³⁰ See, e.g., *id.*

²³¹ See *Sax & Hiestard*, *supra* note 40, at 886-87.

²³² Text accompanying notes 94-104 *supra*.

comparison classes, there is no reason not to give a remedy to the students who suffered an educational loss. A comparative analysis broken down, for example, by IQ groups within a class, would permit identification of the "injured" groups for purposes of deciding who should receive remedial instruction.

c. Proof of Causation of Harm on an Individual Basis

If "cause in fact" and "harm" are proven on a class basis, relief in the form of remedial instruction or dismissal of an incompetent teacher could be awarded without a showing of harm to each individual student. If compensation is sought for diminished future earnings, however, the individual student probably must prove that he or she suffered harm because of the teacher's negligence.

Depending on the availability of the necessary data, the comparative method might be used to prove that an individual student's failure to learn was "caused" by the negligence of his teacher. Consider the following hypothetical. While performing an operation, a doctor negligently performs a certain procedure and the patient dies. Assume that when this operation is properly (non-negligently) performed, there is a two percent chance that the patient will die. When this particular act of negligence is committed, there is a fifty percent chance of death. Presumably there would be no objection to allowing a jury to find that the negligence of the doctor was the "cause in fact" of the patient's death. Even though there is some possibility that the patient would have died even if the doctor had not been negligent, it is more likely than not that the patient would not have died "but for" the doctor's negligence.²³³ Although the doctor may rebut the presumption created by the statistics by proving that the patient was among the two percent who would have died in a non-negligent operation, the possibility that without the doctor's negligence the patient would still have died²³⁴ does not preclude a verdict for the patient.

This principle may be applied to education by isolating, in both the plaintiff and comparison classes, those students with the

²³³ The preponderance of the evidence standard usually applied in civil cases is, according to McCormick, proof that leads the jury to find the existence of a contested fact more probable than its non-existence. MCCORMICK, *supra* note 221, § 339, at 794 n.56.

²³⁴ This possibility exists in many tort cases. In the typical case of the plaintiff's slipping on a wet floor that the defendant negligently failed to mop, the possibility that plaintiff would still have fallen if the floor had been dry does not of itself make proof of cause impossible.

individual plaintiff's essential characteristics, and comparing the performance of those sub-classes. Suppose that in the comparison classes an average of ninety percent of the students with the same essential characteristics as the plaintiff progressed at least one grade level in reading in the fifth grade. In the plaintiff class, only forty percent of the students with the plaintiff's essential characteristics advanced at least one grade level. The plaintiff failed to advance a grade level in reading (and perhaps was held back a year). Because the teacher is the only causal factor not held constant between the two sub-classes, it can be inferred, in the absence of evidence to the contrary, that the different achievement rates are attributable to differential teacher input. While it is possible that the plaintiff would not have progressed at least one grade level even if he had been in one of the comparison classes, it is more likely than not that, but for the teacher's negligence, the plaintiff would have advanced at least one grade level.²³⁵

Perhaps the plaintiff should be required to introduce evidence that he is a typical or average member of the plaintiff sub-class—that there is no reason to place him within the ten percent who would have failed to progress at least a grade level even with a non-negligent teacher. For example, he might produce evidence that his behavior, diligence, and attentiveness were at least average for students with his "essential characteristics." This showing should at least create a rebuttable presumption or permit the inference that, "but for" the teacher's negli-

²³⁵ See McCORMICK, *supra* note 221, § 339, at 794; RESTATEMENT (SECOND) OF TORTS § 328 D, comments *d* & *e* at 158-59 (1965).

This more-likely-than-not determination may be derived as follows: Since 10% of those in the comparison class with plaintiff's essential characteristics (the "comparison sub-class") failed to advance one grade level, that percentage of those in the plaintiff class with plaintiff's essential characteristics (the "plaintiff sub-class") in excess of 10% who failed to advance one grade level was caused by the defendant teacher's input. Accordingly, since 40% of the plaintiff sub-class failed to advance one grade level, the failure of 30% (=40%–10%) of the plaintiff sub-class to advance one grade level was caused by the input of defendant teacher. The probability that the failure of a student in the plaintiff sub-class to advance one grade level was caused by the defendant teacher is the number of students in the plaintiff sub-class whose failure to advance one grade level was caused by the defendant teacher divided by the number of students in the plaintiff sub-class who failed to advance one grade level. Thus, the probability that a given student's failure to advance one grade level was caused by the defendant teacher is $75\% \left(\frac{30\% \times \text{number of students in plaintiff sub-class}}{40\% \times \text{number of students in plaintiff sub-class}} = .75 \right)$. Since 75% is greater than 50%, it is more likely than not that the failure of one of those in the plaintiff sub-class who failed to advance one grade level was caused by the defendant teacher's input.

gence, the plaintiff would have advanced at least one grade level. The defendant could, of course, rebut this presumption with evidence that the plaintiff probably would not have advanced a grade level even if the teaching had been non-negligent because, for example, he was absent often. This method of proving causation of harm to the individual student does not provide a less precise indication of what would have happened "but for" the defendant's negligence than does reliance on general "world experience" in more usual negligence cases.²³⁶

²³⁶ A problem with this method of proof arises when the standard of harm is not fixed. In the above example it was assumed that the minimum level of advancement was failure to advance one grade level. Suppose, however, that in the plaintiff sub-class 80% of the students failed to advance at least 1.2 grade levels while 40% of the students failed to advance at least 1.0 grade level. Assume further that 30% of the comparison sub-class failed to advance at least 1.2 grade levels while 25% of the comparison sub-class failed to advance at least 1.0 grade level. Under these circumstances, the probability that the failure of a student in the plaintiff sub-class to advance at least 1.2 grade levels was caused by the teacher is 62.5%. The probability that the failure of a student in the plaintiff sub-class to advance at least 1.0 grade level was caused by the teacher, however, is 38%. Therefore, although it is more likely than not that a student's failure to advance 1.2 grade levels was caused by the defendant teacher, it is more likely than not that a student's failure to advance 1.0 grade level was not caused by the defendant teacher. In such circumstances the choice of the minimum level of advancement with reference to which the harm will be identified—the choice between failure to advance at least 1.0 and 1.2 grade levels in this example—is crucial, and thus susceptible to manipulation.

If, fortuitously, the percentage of students in the comparison sub-class failing to advance beyond each level remains in a constant proportion to the percentage of students in the plaintiff sub-class failing to advance beyond each respective level, this problem is guaranteed not to arise. More realistically, even if the proportion is not constant, it may not vary sufficiently to change the more likely than not determination. Suppose, for example, that 80% of the plaintiff sub-class failed to advance at least 1.2 grade levels, 40% of the plaintiff sub-class failed to advance at least 1.0 grade level, 30% of the comparison sub-class failed to advance at least 1.2 grade levels, and 10% of the comparison sub-class failed to advance at least 1.0 grade level. Although the probability that the defendant teacher caused the failure of a student in the plaintiff sub-class to advance 1.2 grade levels is 62.5%, while the probability that the defendant teacher caused the failure of a student in the plaintiff sub-class to advance 1.0 grade level is 75%, in both cases it is more likely than not that the teacher was the cause. If the plaintiff can establish harm due to teacher inputs over most of the range of progress levels, he might succeed in making out a *prima facie* case even when results conflict between any two levels.

²³⁷ See notes 94-104 *supra* & accompanying text. The statistically determined average worst performance in comparison classes would naturally be the product of performances above and below the average, all of which represent the worst performances in each class or program in the comparison classes, including performances which might be found negligent. If graphed, these performances might appear approximately as a normal curve with the mean being the standard of minimum professional competence for communities of comparable essential characteristics. Teachers whose performances fall above the mean will not be found negligent even though their performances are the worst in their respective schools. Arguably, because of the imperfection of measurement, teachers whose performances are clustered just below the mean should not be found negligent. Teachers whose performances fall in the extreme tail of the curve below the mean would clearly be negligent. The point "significantly" below the mean at which

2. Proof of Negligence

a. *The Comparative Method*

The comparative method outlined above does not establish teacher negligence; it establishes only that the quality of a teacher's performance is inferior to that of the teachers of comparison classes. To establish negligence, the plaintiff must prove that the defendant's performance is worse than that of the minimally acceptable teacher in the same or similar communities. In light of the comparative method of proof, this definition of negligence may be translated into the following standard: A teacher is negligent if it is proven that his or her performance falls significantly below the average worst performance of teachers in comparison classes identical in all essential respects with the plaintiff class.²³⁷

One method of proving that the defendant teacher's performance falls below this standard relies on an inference of the existence of an unobserved fact from proof of the existence of an observed fact. The inference, similar to that employed under the doctrine of *res ipsa loquitur*,²³⁸ is that one teacher's students do not perform significantly worse than the average worst performance of other teachers' students identical in all essential respects unless the individual teacher's performance is below the average worst performance of teachers in the community.²³⁹ Given this inference and standard of negligence, negligence may be established by proof that the performance of the plaintiff class falls significantly below the average worst performance of the comparison classes. Medical malpractice cases provide ample authority for proving negligence by circumstantial evidence.²⁴⁰

Suppose that in a ghetto school over a ten-year period, the first-year French classes of teacher *A* have averaged in the fifth percentile on year-end achievement tests. Average scores in individual years ranged between the fourth and sixth percentile. In the comparison schools, the students of the worst teachers have

performance becomes inexcusable would have to be determined in the courts through litigation. Although policy would play the major role in the fixing of this point, a plaintiff might strengthen his case by showing, when the requisite data is available, that defendant's performance is more than one or two standard deviations below the mean.

²³⁸ See sources cited note 219 *supra*.

²³⁹ See RESTATEMENT (SECOND) OF TORTS § 328 D, comments *f* & *g* at 160-62 (1965).

²⁴⁰ See *Ybarra v. Spangard*, 25 Cal. 2d 486, 154 P.2d 687 (1944); W. PROSSER, *supra* note 25, § 39, at 226-28; see note 222 *supra*. But see *Olson v. North*, 276 Ill. App. 457, (1934); Wade, *supra* note 52, at 228 & nn.67, 68.

averaged in the fifteenth percentile and the comparison groups overall have averaged in seventeenth percentile. Unless it is shown that these test results were "caused" by a factor other than teacher input, it reasonably could be concluded that the performance of teacher *A* failed to meet minimum professional standards.

b. *Lack of Certification*

The extent to which lack of certification²⁴¹ should be independent evidence of a teacher's negligence is unclear. It has been suggested that an uncertified or unlicensed professional should be held strictly liable for injuries caused in the performance of a function requiring certification or license. In *Biakanja v. Irving*,²⁴² for example, the defendant, who was not licensed to practice law as required by statute, was held to be negligent per se in a suit arising from his drafting of a faulty will. In the education context, this view implies that an uncertified teacher would be negligent per se or strictly liable if his classes failed to obtain the average level of performance for students with the same essential characteristics.²⁴³

Other authorities suggest that lack of certification is evidence of negligence where injury results from performance of a function for which certification is required by law.²⁴⁴ Some support for the application of this theory is provided by *Kobylski v. Board of Education*,²⁴⁵ in which a New York court held that the failure of a teacher to have a valid teaching certificate could constitute substantial evidence of incompetence in a dismissal proceeding. This theory could result in finding an uncertified teacher negligent where he followed the same procedures and obtained the same results as a certified teacher, who might not be found negligent.

Perhaps the best view is that of the majority of the New York Court of Appeals in *Brown v. Shyne*:²⁴⁶ Lack of statutorily required certification is evidence of negligence only where it is

²⁴¹ It has been suggested that there is a presumption of competence on the part of a properly certified teacher. E. REUTTER & R. HAMILTON, *supra* note 14, at 450. This presumption, however, must be subject to rebuttal by the kinds of evidence discussed in this section.

²⁴² 310 P.2d 63 (Cal. Dist. Ct. App. 1957), *aff'd in part*, 49 Cal. 2d 647, 320 P.2d 16 (1958).

²⁴³ See text accompanying notes 221-24 *supra*.

²⁴⁴ E.g., *Brown v. Shyne*, 242 N.Y. 176, 151 N.E. 197 (1926) (Crane, J., dissenting).

²⁴⁵ 33 App. Div. 2d 603, 304 N.Y.S.2d 453 (1969).

²⁴⁶ 242 N.Y. 176, 151 N.E. 197 (1926).

logically relevant to a showing that the defendant failed to meet the standard of conduct required of certified members of the profession—for instance, where the defendant was unable to obtain a certificate because of unsatisfactory practice teaching. The theories that impose a higher standard on uncertified teachers, however, may have the arguably desirable effect of discouraging uncertified people from teaching.

The extent to which lack of certification indicates negligence by the officials who hired the uncertified teacher is also unclear. The determination of whether hiring an uncertified teacher constitutes negligence per se, evidence of negligence, or nothing in itself, might depend on the statutory requirements for hiring and whether or not the hiring of uncertified teachers should be discouraged. It may also be asked whether the fact that an incompetent teacher is certified conclusively proves that the school district was not negligent in hiring him (apart from possible vicarious liability). It can be argued that a school district is acting per se reasonably where it hires a certified teacher because it can reasonably rely on the teaching certificate as conclusive proof that the teacher is minimally competent. While certification may be a defense against a claim of administrator negligence during the first year of the teacher's employment, a school district clearly could be negligent in retaining or rehiring a certified teacher who performed poorly during the first year. Furthermore, a school district might be found negligent for hiring a certified but incompetent teacher of whose past or probable incompetence school officials had knowledge, perhaps from poor letters of recommendation.

c. *Other Types of Proof*

Evaluations of a teacher by his or her principal or supervisor might provide other evidence of teacher negligence.²⁴⁷ If, on the basis of observation, a principal or supervisor rated a teacher's performance unsatisfactory, these evaluations might be available to the plaintiff as evidence of the teacher's negligence or incompetence; moreover, if a principal or supervisor rated a teacher unsatisfactory but failed to dismiss the teacher "for cause" or rehired the teacher, this would seem to be evidence that the supervisor or principal was negligent.

As was suggested earlier,²⁴⁸ the unexcused failure of a

²⁴⁷ See *Conley v. Board of Educ.*, 143 Conn. 488, 123 A.2d 747 (1956), in which a teacher's supervisor testified about the teacher's shortcomings in a dismissal proceeding.

²⁴⁸ Notes 145-63 *supra* & accompanying text.

teacher or school official to conform to statutes or regulations enacted to protect students against the risk of not learning may constitute negligence per se or evidence of negligence.²⁴⁹ If, for example, a teacher failed to follow a school district regulation requiring that a certain percentage of class time be used for reading instruction, and the students fell behind their grade level in reading, violation of the regulation may constitute negligence per se or evidence of negligence. Failure of a school official to follow statutorily prescribed hiring criteria also may constitute negligence per se or evidence of negligence if he hires an incompetent teacher who causes educational harm to students. On the other hand, compliance with statutes and regulations does not preclude a finding of negligence.²⁵⁰

Where a teacher has taken a "teaching test,"²⁵¹ his performance on the test might be introduced (along with expert testimony) as evidence of negligence or incompetence. If the defendant performed well on the test, he might introduce the results to prove his competence or non-negligence.

Teacher negligence might also be established by evidence that the teacher did not follow conventional teaching methods, or at least methods recognized by a substantial portion of the profession.²⁵² In *Gardner v. State*,²⁵³ for example, the state of New York was held liable on a negligence theory for injuries sustained by a student caused by the failure of a gym teacher to give gymnastic instruction according to customary methods.²⁵⁴ This is not to say, of course, that mere deviation from traditional teaching methods alone should constitute negligence.²⁵⁵ If a re-

²⁴⁹ See RESTATEMENT (SECOND) OF TORTS §§ 286, 288 B (1965).

²⁵⁰ *Id.* § 288 C.

²⁵¹ See *Lubell v. Nyquist*, 31 App. Div. 2d 569, 294 N.Y.S.2d 961 (1968), *appeal denied*, 23 N.Y. 645, 298 N.Y.S.2d 1027 (1969); note 222 *supra*.

²⁵² See notes 94-104 *supra* & accompanying text.

²⁵³ 281 N.Y. 212, 22 N.E.2d 344 (1939). See *Keese v. Board of Educ.*, 37 Misc. 2d 414, 235 N.Y.S.2d 300 (Sup. Ct. 1962), in which a gym teacher's deviation from a syllabus was considered evidence of negligence.

²⁵⁴ It has been suggested that an attorney's deviation from customary methods should constitute negligence if he fails to accomplish the desired objective. Wade, *supra* note 52, at 227 & n.58. A recent law review comment, moreover, has contended that a professional's deviation from established procedures should create a rebuttable presumption of negligence. *Professional Negligence*, *supra* note 51, at 645; see generally Curran, *supra* note 95, at 4-6. A possible objection to using deviation from conventional procedures as an indicium of negligence is that it might discourage experimentation and restrict development of new and better educational methods. For an answer to this objection, see text accompanying notes 52-55 *supra*.

²⁵⁵ Under some circumstances there may be constitutional problems with requiring a teacher to follow particular teaching methods. Cf. *Webb v. Lake Mills Community School Dist.*, 344 F. Supp. 791 (N.D. Iowa 1972).

spected segment of the educational community recognizes or adheres to the method, the deviation should not be considered negligent, even if, in a particular case, students learned less than they probably would have if taught by conventional methods.

III. PRIVATE EDUCATION

The case of the public school student presents the most difficulties and has the least chance of success of any suit by a student who fails to learn because of teacher negligence. The private school student who fails to learn because of teacher negligence could use most of the legal arguments and methods of proof developed in the public school context²⁵⁶ unencumbered by several of the difficulties encountered in the public school suit. Governmental immunity would not bar recovery, although charitable immunity doctrines might;²⁵⁷ the doctrine of *respondet superior* is more likely to render the private school liable for the acts and omissions of its teachers than the public school; and the existence of a contract upon which to base a breach of contract theory is not at issue.²⁵⁸ It is even possible in the private school case that the promise of non-negligent instruction will be express, either oral or written. If not, it is perhaps easier to find an implied promise of non-negligent instruction than in the public school situation. Furthermore, teacher negligence aside, it may be possible to find a promise or warranty of a minimum level of student performance or subsequent educational opportunity, either expressed in the contract or implied by advertising or other promotional representations.²⁵⁹ In the event of breach, the amount of tuition paid is a measure of damage seemingly less speculative than any of the damages assertible in the public school situation.²⁶⁰

A troublesome feature of the private school case is that the private school is not as effective a risk bearer or distributor as a

²⁵⁶ Obviously, liability could not be based on the kinds of statutes discussed in text accompanying notes 145-63 *supra*.

²⁵⁷ See W. PROSSER, *supra* note 25, § 133.

²⁵⁸ See, e.g., *Arthur Murray, Inc. v. Parris*, 243 Ark. 441, 420 S.W.2d 518 (1967) (student recovered prepaid tuition for unused lessons because dance studio breached contract by failing to provide competent instruction); *Olson v. Glen Falls Ins. Co.*, 181 Cal. App. 2d 165, 5 Cal. Rptr. 233 (Dist. Ct. App. 1960); *Sciortino v. Leach*, 242 So. 2d 269 (La. Ct. App. 1970).

²⁵⁹ See *Arthur Murray, Inc. v. Parris*, 243 Ark. 441, 420 S.W.2d 518 (1967). See generally Note, *Developing Protection for the Consumer of Future Services*, 72 COLUM. L. REV. 926 (1972).

²⁶⁰ See *id.*; *Olson v. Glen Falls Ins. Co.*, 181 Cal. App. 2d 165, 5 Cal. Rptr. 233 (Dist. Ct. App. 1960); *Stad v. Grace Downs Model & Air Career School*, 65 Misc. 2d 1095, 319 N.Y.S.2d 918 (Queens County Civ. Ct. 1971).

public entity. While tuition refunds might not cripple the school, the broader damages discussed in the public school context might be ruinous. If insurance is available, however, a suit for failure to learn remains more likely to succeed in the private than in the public school context. This greater likelihood of success also applies to suits against private colleges and universities.²⁶¹

A student in a professional or occupational training course also might bring a successful suit to recover for his failure to learn. For example, a student in a computer repair course would have a strong contract or tort case if the techniques he was taught applied only to computers of a type no longer used by anyone.²⁶² Problems of proof are clearly less troublesome than in the public school situation. Damages would not be speculative, and could encompass not only tuition but provable loss of income if the student gave up a job in expectation of learning a new occupation. If a technical training course falsely represents that graduates will find employment, deceit or negligent misrepresentation would provide a plausible basis for an action for tuition refund or more extensive damages.²⁶³

A final possible situation in which a suit for failure to learn because of teacher negligence could be brought with the legal theories and methods of proof outlined in this Comment might arise where a bar review course fails to teach the students the correct law. An important change in the law, for example, is not incorporated into the review course. The negligence of the instructor seems easily provable.²⁶⁴ The comparative methods could be used to prove cause and harm. Suppose the normal bar exam pass rate of similarly composed review classes is eighty percent and the pass rate in the plaintiff's incorrectly instructed class was thirty percent. Over a ten-year period the lowest pass rate of any non-negligently instructed class was seventy percent. Out of a class of one hundred students who took the course, it could be argued that twenty would have failed even if the instruction had been non-negligent, and the failure of the remaining fifty is attributable to the negligent instruction. Thus, all

²⁶¹ See *Paynter v. New York Univ.*, 64 Misc. 2d 226, 314 N.Y.S.2d 676 (N.Y. County Civ. Ct. 1970), *rev'd*, 66 Misc. 2d 92, 319 N.Y.S.2d 893 (App. T. 1971).

²⁶² See Note, *supra* note 259; *cf. Sciortino v. Leach*, 242 So. 2d 269 (La. Ct. App. 1970).

²⁶³ See *Stad v. Grace Downs Model & Air Career School*, 65 Misc. 2d 1095, 319 N.Y.S.2d 918 (Queens County Civ. Ct. 1971); *Brown v. Search*, 131 Wis. 109, 111 N.W. 210 (1907); W. PROSSER, *supra* note 25, §§ 109-10, at 728-36.

²⁶⁴ See text accompanying notes 237-55 *supra*.

things being equal, it is more likely than not that the failure of any particular student was caused by the negligent instruction. Of course, it would be open to the defendant to prove that a particular student's failure is attributable to something other than the negligence of the instruction, for instance, the student's failure to attend the classes.²⁶⁵ In the case of a homogeneous group, however, any member of the class could use this method to establish that, more likely than not, he would have passed "but for" the negligence of the instructor. In a negligence action, proximate cause would easily be established, since the risk created by negligent instruction in a bar review course clearly is that students will fail the bar exam.

The plaintiff's case might be strengthened by a showing that he was an outstanding law student who had diligently prepared for the bar exam. A less outstanding plaintiff should try to show that he was typical of the group who took the course, that is, that there is no reason to believe that he was more likely to fail than anyone else.

Calculation of damages is also easier in this situation than in the public school context. Beyond tuition refund, the students who failed the bar exam could be compensated for income lost while they retook the course and waited for the exam results. Recovery might also be possible, on a more speculative basis, for loss of a job because of failing the bar exam. Finally, even those who passed the exam might be able to recover tuition on a contract theory, because they did not receive that for which they bargained.

IV. CONCLUSION

At the present time, the problems involved in bringing a suit for failure to learn because of teacher negligence or incompetence may seem insurmountable. Traditional legal principles, however, provide ample guidance for fashioning a viable cause of action.

First, failure to learn is not a harm beyond the law's remedial capabilities. The replacement of incompetent by competent teachers, the provision of, or payment for, remedial instruction, and monetary compensation for diminished future income could "make whole" public school students who have suffered a loss of educational benefits.

Second, tort law, contract law, and mandamus provide legal theories on which a suit for failure to learn might be based. A

²⁶⁵ See text accompanying notes 219-36 *supra*.

negligence suit stands the most chance of success; various statutory, common law, and scholarly authorities support the contention that school districts and teachers should be held liable for the failure of students to learn because of the negligence of the teachers. The standard of acceptable instruction should be comparative, that is, the level of skill and learning of the minimally acceptable teacher in the same or similar communities. In limited circumstances, causes of action based on intentional tort or misrepresentation may also be available. Contract law may supply the public school student with a cause of action if the factfinder can be persuaded of the existence of implied contracts between the student and the teacher or between the student and the school district, with an implied promise of non-negligent instruction. Although in many cases the contract theory may be less plausible than the tort theory, the contract approach has several advantages: Governmental immunity, which may bar recovery in tort, might not preclude a successful contract action; courts may be more willing to allow recovery for loss of an expectancy or benefit in contract than in tort; defenses such as contributory negligence or assumption of risk may bar recovery in tort but not in contract; and statutes of limitations are generally longer for contract actions. A contract theory would, of course, be of more use to a private school student than to a public school student. Finally, in narrowly defined circumstances, mandamus may provide minimal relief.

Third, there are several methods of proving teacher negligence and causation of harm. The latter can be established if the plaintiff proves that a class of which he was a member performed significantly worse than did classes identical in all essential respects except that they were not taught by the defendant teacher. Negligence can be established if the plaintiff proves that the teacher's performance fell significantly below the average worst performance of teachers in classes identical to the plaintiff's in all essential respects. Lack of certification, a supervisor's poor evaluations, failure to conform to statutory educational requirements, and failure to use recognized teaching methods might provide other evidence of negligence.

The legal framework for a cause of action for failure to learn is supported by strong policy considerations, including the importance of education, the ability of teachers and school districts to bear or spread the costs of students' failure to learn, and the desirability of deterring negligent teaching and the hiring of incompetent teachers.

The novelty of the theories advanced in this Comment does not condemn educational malpractice suits to an eternity of sustained demurrers and motions to dismiss for failure to state a cause of action. Dean Prosser's tribute to the flexibility of tort law is an acknowledgement of the dynamism of the common law generally:

[T]he progress of the common law is marked by many cases of first impression, in which the court has struck out boldly to create a new cause of action, where none had been recognized before. . . . The law of torts is anything but static, and the limits of its development are never set. When it becomes clear that the plaintiff's interests are entitled to legal protection against the conduct of the defendant, the mere fact that the claim is novel will not of itself operate as a bar to recovery.²⁶⁶

²⁶⁶ W. PROSSER, *supra* note 25, § 1, at 3 (footnote omitted).

IMPLEMENTING TITLE IX: THE HEW REGULATIONS

Title IX of the Education Amendments of 1972, signed into law on June 23, 1972, prohibits sex discrimination in education.¹ This provision was enacted in response to extensive hearings held by the House Special Subcommittee on Education, which documented nationwide sex discrimination in education.² Senator Birch Bayh of Indiana urged his colleagues to take action in this area:

[O]ne of the great failings of the American educational system is the continuation of corrosive and unjustified discrimination against women. It is clear to me that sex discrimination reaches into all facets of education—admissions, scholarship programs, faculty hiring and promotion, professional staffing, and pay scales. Indeed, the recent "Report on Higher Education" . . . concluded,

Discrimination against women, in contrast to that against minorities, is still overt and socially acceptable within the academic community.³

The main provision of Title IX is an absolute prohibition, similar to that of Title VI of the Civil Rights Act of 1964:⁴ "No person in the United States shall, on the basis of sex, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any education program or activity receiving Federal financial assistance"⁵ Regulations implementing Title IX, promulgated by the Department of Health, Education, and Welfare, became effective on July 21, 1975.⁶

¹ Act of June 23, 1972, Pub. L. No. 92-318, 36 Stat. 373, (codified at 20 U.S.C. §§ 1681-86 (Supp. II, 1972)).

² *Hearings on § 805 of H.R. 16098 Before a Special Subcomm. of the House Comm. on Education and Labor*, 91st Cong., 2d Sess. (1970) [hereinafter cited as *1970 Hearings*].

³ 118 CONG. REC. 5803 (1972) (remarks of Senator Bayh).

⁴ 42 U.S.C. § 2000d (1970).

⁵ 20 U.S.C. § 1681(a) (Supp. II, 1972). Title VI of the Civil Rights Act of 1964 forbids discrimination on the ground of race, color, or national origin in any program receiving federal financial assistance. 42 U.S.C. § 2000d (1970).

⁶ 40 Fed. Reg. 24128 (1975). HEW spent two years preparing the Title IX implementing regulations. On June 20, 1974, the Office of Civil Rights presented its proposed regulations. 39 Fed. Reg. 22228 (1974). In order to accommodate the expected flood of reaction from educational institutions and women's groups, comments were accepted

This comment will first develop from the legislative history, from executive and judicial interpretation of Titles VI and VII of the Civil Rights Act of 1964,⁷ and from relevant constitutional adjudication, a framework with which to approach Title IX. The framework will then be applied to evaluate the HEW regulations as an implementation of the mandate of Title IX in the substantive areas of admissions and recruitment, access to classes and activities, behavior and appearance rules, use of marital or parental status, facilities, and athletics.

I. THE STATUTE

The absolute prohibition of section 901(a) of Title IX,⁸ is followed by several exceptions relating to admissions.⁹ Section 901(a) applies only to vocational, professional and graduate schools, and public undergraduate schools.¹⁰ Public undergraduate schools that have had a continual tradition from their establishment of admitting only students of one sex are exempted from the prohibition against sex discrimination in admissions.¹¹ Once a student is admitted, however, there can be no sex-based discrimination.¹² Educational institutions run by religious organizations are exempted insofar as application of Title IX would be inconsistent with the religious tenets of the organization.¹³ A complete exemption from the statute is provided educational institutions whose primary purpose is training

through October 15, 1974. *Id.* 22231. Over 9,700 comments were received by the Department. 40 Fed. Reg. 24128 (1975).

⁷ 42 U.S.C. §§ 2000d, 2000e (1970).

⁸ 20 U.S.C. § 1681(a) (Supp. II, 1972); text accompanying note 5 *supra*.

⁹ 20 U.S.C. §§ 1681(a)(1), (5) (Supp. II, 1972):

(1) In regard to admissions to educational institutions, this section shall apply only to institutions of vocational education, professional education, and graduate higher education, and to public institutions of undergraduate higher education;

....

(5) In regard to admissions this section shall not apply to any public institution of undergraduate higher education which is an institution that traditionally and continually from its establishment has had a policy of admitting only students of one sex.

For a section by section analysis of the statute in light of its legislative history, see Buck & Orleans, *Sex Discrimination—A Bar to a Democratic Education: Overview of Title IX of the Education Amendments of 1972*, 6 CONN. L. REV. 1 (1973).

¹⁰ 20 U.S.C. § 1681(a)(1) (Supp. II, 1972).

¹¹ 20 U.S.C. § 1681(a)(5) (Supp. II, 1972); see Shelton & Berndt, *Sex Discrimination in Vocational Education: Title IX and Other Remedies*, 62 CALIF. L. REV. 1121 (1974).

¹² HEW FACT SHEET 3 (June, 1975).

¹³ 20 U.S.C. § 1681(a)(3) (Supp. II, 1972).

individuals for the military services.¹⁴ Section 901(b) is an anti-quota provision:

Nothing contained in subsection (a) of this section shall be interpreted to require any educational institution to grant preferential or disparate treatment to the members of one sex on account of an imbalance which may exist with respect to the total number or percentage of persons of that sex participating in or receiving the benefits of any federally supported program or activity, in comparison with the total number or percentage of persons of that sex in any community, State, section, or other area¹⁵

The only other exception to the absolute prohibition is section 907: "Notwithstanding anything to the contrary contained in this chapter, nothing contained herein shall be construed to prohibit any educational institution receiving funds under this Act, from maintaining separate living facilities for the different sexes."¹⁶

On December 31, 1974, section 901¹⁷ was amended to exempt fraternities, sororities, and youth service organizations from the prohibitions of Title IX.¹⁸ The amendment resulted from the flood of objections received by HEW¹⁹ to section 86.31(b)(7) of the proposed regulations, which would have left open the possibility of educational institutions losing their federal funds if found substantially to support an organization that discriminates by sex.²⁰ This newest amendment and the admissions exemptions reflect the ambivalence of the Congress in its

¹⁴ *Id.* § 1681(a)(4).

¹⁵ *Id.* § 1681(b).

¹⁶ *Id.* § 1686.

¹⁷ *Id.* § 1681(a).

¹⁸ Act of Dec. 31, 1974, Pub. L. No. 93-568, § 3(a), 88 Stat. 1862, *amending* 20 U.S.C. § 1681(a) (Supp. II, 1972).

¹⁹ N.Y. Times, Nov. 25, 1974, at 23, col. 4 (city ed.).

²⁰ 39 Fed.Reg. 22235 (1974):

86.31 Education programs and activities:

(b) [A] recipient shall not, on the basis of sex:

(7) Aid or perpetuate discrimination against any person by assisting any agency, organization, or person which discriminates on the basis of sex in providing any aid, benefit or service to students

Senator Bayh, the primary Senate sponsor of Title IX, 117 CONG. REC. 30155 (1971), proposed the new amendment to make explicit what he considered Congress' intent that the Act not extend to such organizations. 120 CONG. REC. 21567-68 (daily ed. Dec. 16, 1974). There was no problem in getting it passed by the House, because a House conference report had attempted to achieve the same objective by generating legislative history

attempt to abolish the most harmful effects of sex discrimination while responding to political pressure to keep the status quo in some areas.²¹

Section 902 of Title IX²² provides enforcement machinery identical to that of section 602 of Title VI of the Civil Rights Act of 1964,²³ but limited to education programs or activities. Each department and agency empowered to extend federal financial assistance is directed to issue rules and regulations to implement the statute. If after a hearing it is determined that a recipient is not complying with the rules and that future compliance cannot be effected on a voluntary basis, compliance may be enforced through termination of funds or refusal to grant further assistance. A department that takes such action must file a written report with the committees of the House and Senate having legislative jurisdiction over the program or activity involved. Judicial review is authorized by section 903,²⁴ again in language almost identical to that of Title VI.²⁵

II. ANALYSIS OF THE STATUTE

Discrimination against female students in education has taken many and varied forms. It has ranged from overt exclusion from particular classes such as shop, to more subtle discrimination such as inculcation of limited career orientations in female students. This diversity in modes of discrimination necessitates an assessment of the intended scope of Title IX. Is every classification by sex impermissible? Does the statute reach practices that are facially neutral but have a disparate effect on one sex? To what extent is separate but equal a permissible alternative?

to defeat HEW's interpretation of Title IX. 120 CONG. REC. 11106-07 (daily ed. Nov. 26, 1974).

Representative Green of Oregon, the author of the statute, 117 CONG. REC. 9822 (1971), put into the *Congressional Record* on Nov. 26, 1974, the substance of the recommendation of the House conference report: "[Title IX] was never designed for the purpose of having the Federal Government intrude on private organizations and to force by Government fiat the integration of such groups as Boy Scouts, Girl Scouts, . . . and all sororities and fraternities." 120 CONG. REC. 11106 (daily ed. Nov. 26, 1974) (remarks of Representative Green). Representative Green suggested other changes in the proposed HEW regulations that will be discussed below. See text accompanying notes 78-229 *infra*.

²¹ See Buck & Orleans, *supra* note 9.

²² 20 U.S.C. § 1682 (Supp. II, 1972).

²³ 42 U.S.C. § 2000d-1 (1970).

²⁴ 20 U.S.C. § 1683 (Supp. II, 1972).

²⁵ 42 U.S.C. § 2000d-2 (1970).

A. *Overt Discrimination*

The practices most obviously covered by Title IX involve overtly different treatment of male and female students. Some elementary schools forbid girls to join the safety patrol. Colleges and universities often prescribe earlier curfews for women than for men. Vocational interest tests have been color coded pink and blue with different career choices for women and men. All of these are examples of explicit discrimination based on sex, prohibited by Title IX. Educational institutions should not be allowed to justify such overtly different treatment. When schools make explicit rules according to sex, Title IX's prohibition should be applied absolutely, with a narrow reading of section 907's "living facilities" exception.²⁶

The legislative history of the statute is not particularly instructive on this interpretive question. Most of the congressional debate focused on the admissions exceptions that eventually became part of Title IX.²⁷ At one point in the debates, however, Senator Bayh referred to Title IX as a "narrower embodiment" of the Equal Rights Amendment (ERA), which Congress had recently sent to the states for ratification.²⁸ The Senate Report on the ERA interprets it as an absolute prohibition of overtly different treatment on the basis of sex.²⁹ No justification by a state would be accepted for overtly disparate treatment under the ERA, and none should be accepted under Title IX.

Executive construction of Title VI of the Civil Rights Act of 1964,³⁰ forbidding discrimination on the basis of race, color, or national origin in any program receiving federal financing, also supports an absolute reading of the statute.³¹ Caution should be exercised, however, since Congress did not limit the effect of Title VI in any way, whereas Title IX has elaborate admissions exemptions and a living facilities exception. Congress obviously does not see race and sex discrimination in exactly the same way. One cannot conceive that Congress would enact a statute allowing higher admissions standards for blacks than whites in the interest of permitting educational institutions to determine the optimal environment for learning. Nor could money be allotted

²⁶ 20 U.S.C. § 1686 (Supp. II, 1972).

²⁷ See, e.g. 118 CONG. REC. 5812-15 (1972); 117 *id.* 30408-12, 39248-61 (1971).

²⁸ 117 CONG. REC. 30414 (1971) (remarks of Senator Bayh).

²⁹ S. REP. NO. 689, 92d Cong., 2d Sess. 2 (1972); see Brown, Emerson, Falk & Freedman, *The Equal Rights Amendment: A Constitutional Basis for Equal Rights for Women*, 80 YALE L.J. 871 (1971) [hereinafter cited as Brown].

³⁰ 42 U.S.C. §§ 2000d *et seq.* (1970).

³¹ See 45 C.F.R. § 80.3 (1974).

to a state system of education in which one school specializing in engineering and science admitted whites only, while another school, set up for blacks, taught only auto mechanics and maintenance work. That is just what the admission exemptions in Title IX allow. Nevertheless, it should not be assumed that because Congress was willing to write in certain exemptions, it did not intend the statute absolutely to prohibit overt sex-based discrimination in the areas not excepted. One might ask whether differences in treatment allowed by the HEW regulations to Title IX would be valid under Title VI, and, if not, whether sex should be viewed differently from race in that particular situation.

An absolute reading of the statute must take account of section 907, which allows "separate living facilities for the different sexes."³² The term "living facilities" may include restrooms, lockers, and other school areas where disrobing takes place; but to extend the term any further would frustrate Congress' attempt to give women equal educational opportunity.³³ A narrow reading of section 907 also conforms to the privacy exception to the ERA, on which much of the legislative history of that amendment is premised.³⁴ The source of this implied exception is the constitutional right of privacy enunciated by the Supreme Court in *Griswold v. Connecticut*³⁵ and *Roe v. Wade*.³⁶ The Senate Report on the ERA indicates that the right of privacy exception extends only to separate restrooms and sleeping quarters.³⁷ Such should also be the limit of the explicit exception of section 907 of Title IX.

The narrow reading given to the "bona fide occupational qualification" (BFOQ) exception to Title VII of the Civil Rights Act of 1964³⁸ also supports a similar approach under Title IX. Title VII forbids discrimination in employment on the basis of race, color, religion, sex, or national origin.³⁹ Such discrimination may be made, however, "in those certain instances where

³² 20 U.S.C. § 1686 (Supp. II, 1972).

³³ Support for a narrow reading of the exception can be found in the Supreme Court's construction of the Fair Labor Standards Act § 13(a)(2), 29 U.S.C. § 213(a)(2) (1970), in *A.H. Phillips, Inc. v. Walling*, 324 U.S. 490 (1945). "To extend an exemption to other than those plainly and unmistakably within its terms and spirit is to abuse the interpretive process and to frustrate the announced will of the people." *Id.* at 493.

³⁴ See note 29 *supra* & accompanying text.

³⁵ 381 U.S. 479 (1965).

³⁶ 410 U.S. 113 (1973).

³⁷ See note 29 *supra* & accompanying text.

³⁸ 42 U.S.C. § 2000e-2(e) (1970).

³⁹ *Id.* § 2000e-2.

religion, sex, or national origin is a bona fide occupational qualification reasonably necessary to the normal operation of that particular business or enterprise."⁴⁰ In Title VII as in Title IX, a general prohibition is qualified by a single exception.

Both the courts and the Equal Employment Opportunity Commission have allowed very few employers to justify different treatment based explicitly on sex under the BFOQ exception. One court held that "sexual characteristics, rather than characteristics that might, to one degree or another, correlate with a particular sex" are the only basis for applying the BFOQ exception.⁴¹ Thus, wet nurses and sperm donors are two of the few occupations that would fit such a narrow reading. Another court imposed on the employer the "burden of proving that he had reasonable cause to believe, that is, a factual basis for believing, that all or substantially all women would be unable to perform safely and efficiently the duties of the job involved."⁴²

In summary, the legislative histories of Title IX and of the ERA and executive and judicial construction of Titles VI and VII support an analysis of Title IX which absolutely proscribes explicitly different treatment of students according to sex, except in the area of living facilities.

B. *Facially Neutral Regulations Having a
Discriminatory Effect*

Some school policies and regulations do not refer explicitly to male and female students and thus appear to be non-discriminatory. Their effect, however, often is to burden female students. Restrictions on part-time attendance at colleges or universities is an example. Although applicable to men and women, women with young children feel the impact of this policy much more than male students, because of the inadequacy of child care facilities in this country. Schools often follow admissions policies that give preference to students from certain schools. If those schools are single-sex institutions, the college in effect discriminates against the sex excluded from the favored single-sex institution.

Title IX is broad enough to cover facially neutral practices having a disparate impact on women. However, the educational institutions should be allowed to justify the necessity of such practices in relation to the objectives of the educational program.

⁴⁰ *Id.* § 2000e-2(e)(1).

⁴¹ *Rosenfeld v. Southern Pac. Co.*, 444 F.2d 1219, 1225 (9th Cir. 1971).

⁴² *Weeks v. Southern Bell Tel. & Tel. Co.*, 408 F.2d 228, 235 (5th Cir. 1969).

Such an interpretation of the statute is supported by parallel decisions under Titles VI and VII of the Civil Rights Act of 1964.⁴³ In *Griggs v. Duke Power Co.*,⁴⁴ the Supreme Court examined neutrally stated employment procedures that were found disproportionately to disqualify blacks. The Court held that the requirement of a high school education or the passing of a standardized general intelligence test as a condition of employment could be sustained only if it had a "manifest relationship" to success in the job.⁴⁵ Lack of discriminatory intent was irrelevant; the effect of the policy triggered application of Title VII.

A similarly broad definition of discrimination was applied in *Lau v. Nichols*.⁴⁶ In *Lau*, Chinese speaking students alleged that the school system violated their rights under Title VI by failing to teach them English. The Court decided that regardless of intent, this failure amounted to discrimination based on national origin prohibited by Title VI. As in *Griggs*, effect was all important. It was not enough that all students were provided with the "same facilities, textbooks, teachers, and curriculum, for students who do not understand English are effectively foreclosed from any meaningful education."⁴⁷ *Lau* and *Griggs* both suggest that a facially neutral requirement that is applied to all candidates for admission to a school or activity will be held to be discriminatory if its effect is to burden a protected group.⁴⁸ Thus even facially neutral policies and regulations may be within the regulatory power of HEW under Title IX. A rule or practice having a disparate impact on women should be allowed only if the school shows "educational necessity"—that the goal sought by the facially neutral but effectively discriminatory rule cannot be achieved in any other manner.

C. *Regulations Concerning Unique Physical Characteristics*

Schools sometimes enact rules based on physical characteristics unique to one sex or the other. It must be asked whether, and if so, under what circumstances, Title IX forbids such rules. Pregnancy is usually the characteristic at issue. Both the Equal

⁴³ 42 U.S.C. §§ 2000d, 2000e (1970).

⁴⁴ 401 U.S. 424 (1971).

⁴⁵ *Id.* at 432.

⁴⁶ 414 U.S. 563 (1974).

⁴⁷ 414 U.S. at 566.

⁴⁸ See text accompanying notes 44-46 *supra*.

Employment Opportunity Commission regulations under Title VII,⁴⁹ and the HEW regulations implementing Title IX,⁵⁰ apply to various practices of employers and schools relative to pregnant women. A federal district court recently held that an employer's disparate treatment of pregnant employees was not cognizable under Title VII.⁵¹ In so holding the court relied on footnote twenty in *Geduldig v. Aiello*,⁵² where the Supreme Court, in holding that California's disability insurance program did not violate the equal protection clause, rejected the contention that the pregnancy classification there involved was sex-based. The district court considered the definition of discrimination based on sex to be the same under the fourteenth amendment and under Title VII, and therefore considered itself bound by the Supreme Court's analysis in *Aiello*.⁵³

On appeal, the Second Circuit rejected the district court's analysis, admonishing the court for reading the *Aiello* language out of the factual context in which it was used,⁵⁴ and holding that in implementing Title VII the Equal Employment Opportunity Commission is not bound by the narrow fourteenth amendment definition of sex-based classifications suggested in *Aiello*.⁵⁵ This broader view is consistent with the approach taken in *Lau* and *Griggs*.⁵⁶ Justice Stewart, in his concurring opinion in *Lau*, indicated that although section 601 of Title VI, standing alone, might not have called for a judgment against the school districts, HEW interpretations of the section required the decision.⁵⁷ He relied on an earlier decision of the Court to hold "that the validity of a regulation promulgated under a general authorization provision such as § 602 of Title VI 'will be sustained so long as it is reasonably related to the purposes of the

⁴⁹ 29 C.F.R. § 1604.10 (1974).

⁵⁰ 40 Fed. Reg. 24137-44 (1975); see text accompanying notes 170-81 *infra*.

⁵¹ *Communications Workers of America v. American Tel. & Tel. Co.*, 379 F. Supp. 679 (S.D.N.Y. 1974), *rev'd*, 513 F.2d 1024 (2d Cir. 1975), *petition for cert. filed*, 44 U.S.L.W. 3067 (U.S. June 19, 1975) (No. 74-1601).

⁵² 417 U.S. 484, 496-97 n.20 (1974).

⁵³ 379 F. Supp. at 682.

⁵⁴ *Communications Workers of America v. American Tel. & Tel. Co.*, 513 F.2d 1024, 1028-30 (2d Cir. 1975), *petition for cert. filed*, 44 U.S.L.W. 3067 (U.S. June 19, 1975) (No. 74-1601).

⁵⁵ *Id.* at 1030-32. "There is," the court noted, "no requirement that the discriminatory practices forbidden by this statute should be limited to practices violative of the Equal Protection Clause. Practices forbidden by Title VII and the EEOC guidelines issued thereunder may, nonetheless, be able to survive Equal Protection attack." *Id.* at 1031.

⁵⁶ See text accompanying notes 44-48 *supra*.

⁵⁷ 414 U.S. at 570-71 (Stewart, J., concurring).

enabling legislation.’”⁵⁸ In *Griggs*, the Court noted that such agency interpretations are entitled to “great deference.”⁵⁹

This criterion should also be used to evaluate the regulations issued under Title IX. What the Court said in *Aiello* in the context of fourteenth amendment litigation should not limit HEW’s attempt to enforce remedial legislation. That a pregnancy classification is not sex-based for fourteenth amendment purposes does not foreclose the constitutional claim, but merely shifts the analysis from the greater burden of justification required for sex-based discrimination by *Reed v. Reed*⁶⁰ and *Frontiero v. Richardson*,⁶¹ to the traditional “rational basis” analysis.⁶² In the same way, such classifications will be examined under Title IX and will be permitted if educational necessity can be demonstrated. But the failure of a pregnancy classification to constitute a sex-based classification for fourteenth amendment purposes and the possibility that it can be justified by a showing of educational necessity should not be relevant to the initial question of the cognizability under Title IX of an attack on the regulation.

D. *The Separate But Equal Doctrine*

Pervading the statutory analysis suggested above is the spectre of the “separate but equal” doctrine. When may an educational institution fulfill its obligations under Title IX by providing separate but equal programs or activities? Proponents of the ERA suggest that under that amendment there is no place for separate but equal. “It would simply operate to perpetuate a dual system of equality, different but not equal. Essentially the

⁵⁸ *Id.* at 571 (quoting *Mourning v. Family Publications Service, Inc.*, 411 U.S. 356, 369 (1973) (footnote omitted)).

⁵⁹ 401 U.S. at 434. In *Communications Workers of America v. American Tel. & Tel. Co.*, 513 F.2d 1024 (2d Cir. 1975), *petition for cert. filed*, 44 U.S.L.W. 3067 (U.S. June 19, 1975) (No. 74-1601), the Second Circuit in part relied on the deference to be accorded agency interpretations of its statutory mandate to hold that the Supreme Court had not intended, contrary to the district court’s holding, to imply that *Aiello* footnote would invalidate EEOC regulations broader than the narrow fourteenth amendment definition of sex-based discrimination there articulated. 513 F.2d at 1030.

⁶⁰ 404 U.S. 71 (1971).

⁶¹ 411 U.S. 677 (1973).

⁶² In *Reed v. Reed*, 404 U.S. 71 (1971), the Supreme Court invalidated a state statute that gave an automatic preference to males in granting letters of administration. Evidencing a sensitivity to the sex classification without finding it a “suspect” classification, the Court found the statute to be without rational basis. *Frontiero v. Richardson*, 411 U.S. 677 (1973), struck down federal statutes wherein the procedures for claiming one’s spouse as a dependent varied between servicemen and servicewomen. Four members of the Court found sex a “suspect” classification while three did not reach that issue since they found the scheme irrational under traditional equal protection analysis.

separate-but-equal doctrine is a device for keeping one group in a subordinate position. . . . Experience has shown, furthermore, that in practice separate-but-equal is rarely in fact equal."⁶³ If it can be shown that a separate program is not equal, there is no question that Title IX is violated. Where the tangible aspects of separate programs for females and males are arguably equal, however, the long tradition of separation of the sexes militates against an automatic rejection of the concept.

An attempt to assess the place of separate but equal under Title IX must begin by looking to the analysis of *Brown v. Board of Education*⁶⁴ that caused the Supreme Court to denounce separation of the races. It might be argued that separation of the sexes is not based on a judgment of inferiority, as was racial segregation, but rather on a conception of the different, complementary roles of women and men. It is, however, just that assumption and inculcation of role that is at the heart of sex discrimination in education.⁶⁵ Only recently has this "equalitarian veneer" been put on the system that has channeled women into a single career while men have been encouraged to reach their educational and career potentials.⁶⁶ In addition to effect on motivation is the even sadder loss of self-esteem occasioned by sex segregation. One elementary school girl wrote in a letter: "Dear God, Are boys better than girls? I know you are one, but please try to be fair."⁶⁷ Although this sense of inferiority and development of sex roles has taken place frequently in integrated environments, it is certainly exacerbated by overt separation.

It has been suggested that Supreme Court cases antedating *Brown* might be used for guidance in evaluating separate activities within schools. In *Sweatt v. Painter*,⁶⁸ the Court ordered the University of Texas Law School to admit a black student because its legal education was superior to that of a state law school established for blacks.

[T]he University of Texas Law School possesses to a far greater degree those qualities which are incapable of

⁶³ *Brown*, *supra* note 29, at 902.

⁶⁴ 347 U.S. 483 (1954).

⁶⁵ See, e.g., Bem & Bem, *Case Study of a Nonconscious Ideology: Training the Woman to Know Her Place*, printed in 1970 Hearings, *supra* note 2, at 1042; Comment, *Teaching Woman Her Place: The Role of Public Education in the Development of Sex Roles*, 24 HASTINGS L.J. 1191 (1973).

⁶⁶ See Bem & Bem, *supra* note 65, at 1043.

⁶⁷ Comment, *supra* note 65, at 1191.

⁶⁸ 339 U.S. 629 (1950).

objective measurement but which make for greatness in a law school. Such qualities, to name but a few, include reputation of the faculty, experience of the administration, position and influence of the alumni, standing in the community, traditions and prestige.⁶⁹

The decision of *McLaurin v. Oklahoma State Regents*⁷⁰ also involved the separate but equal doctrine, but within a single educational institution. The Court held that forcing a black student to sit apart in the classroom, cafeteria, and library impaired "his ability to study, to engage in discussions and exchange views with other students . . ."⁷¹ Buck and Orleans, HEW lawyers, consider these cases "entirely apposite to Title IX."⁷²

They dictate that where separate treatment on the basis of sex is proposed by an entity subject to Title IX, all indicia must indicate that full experiential equality is accorded those who will be affected. Put slightly differently, the treatment proposed must be such as demonstrably would not affect a student or employee's "free choice" among the separate activities, were sex not a factor.

. . . In the multitude of practices subject to this provision, simply the possibility of substantive inequalities, including those derived from the fact of isolation itself, gives rise to a presumption against separate treatment.⁷³

If Title IX is to have its intended remedial effect there must be a presumption against separate treatment of females and males. The reasons asserted for the separate treatment should be relevant to a determination of its acceptability under Title IX. One reason that might be asserted as a justification for separate treatment is the explicit living facilities exception of section 907,⁷⁴ or what the educational entity might think a proper extension of that exception. Also, separate but equal treatment might be necessary at times to forestall an attack by female students under *Lau* and *Griggs*.⁷⁵ For example, it could be argued that opening all competitive athletic teams to female students

⁶⁹ *Id.* at 634.

⁷⁰ 339 U.S. 637 (1950).

⁷¹ *Id.* at 641.

⁷² Buck & Orleans, *supra* note 9, at 19.

⁷³ *Id.*

⁷⁴ 20 U.S.C. § 1686 (Supp. II, 1972).

⁷⁵ See text accompanying notes 44-48 *supra*.

without any separate athletic program for them would effectively shut out the great majority of women from competitive athletics. They would then receive less benefits than their male counterparts in much the same way as the Chinese-speaking students were discriminated against in *Lau*.⁷⁶ A final possible reason school officials might advance for separate programs is the belief that girls learn differently than boys and, therefore, need different environments in which to reach their potentials. Educational authorities could be marshalled on both sides of this issue in the same way the medical authorities contradicted each other in the early sports cases.⁷⁷ Because of the risk that young girls will be channelled into a stereotype of one preparing for very limited future activity and will thereby suffer the sense of inferiority noted in *Brown*, this last rationale should be accorded no place under Title IX.

Separate but equal treatment should be permitted only when an educational entity is within the narrowly interpreted living facilities exception discussed above, or when there is proof that without a separate activity, female students will be, in effect, foreclosed from meaningful participation in the activity and thus discriminated against in the sense recognized in *Lau*.

III. THE REGULATIONS

The principles developed in the preceding paragraphs provide a framework against which to assess the effectiveness of regulations promulgated by HEW as an implementation of the policy of Title IX. The regulations, finalized as Part 86 of Title 45 of the Code of Federal Regulations,⁷⁸ consist of Subparts A through F.⁷⁹ This Comment will not deal with Subpart E (Discrimination on the Basis of Sex in Employment in Educational Programs)⁸⁰ or with Subpart F (Procedures).⁸¹ The discussion will focus on Subparts C (Admission and Recruitment)⁸² and D (Discrimination in Programs and Activities),⁸³ both of which re-

⁷⁶ See text accompanying notes 207-08 *infra*.

⁷⁷ Compare *Fortin v. Darlington Little League, Inc.*, 376 F. Supp. 473 (D.R.I. 1974), *rev'd*, 514 F.2d 344 (1st Cir. 1975) and *Magill v. Avonworth Baseball Conference*, 364 F. Supp. 1212 (W.D. Pa. 1973), *vacated*, 497 F.2d 921 (3d Cir. 1974), with *NOW, Essex County Chapter v. Little League Baseball, Inc.*, 127 N.J. Super. 522, 318 A.2d 33 (1974).

⁷⁸ 40 Fed. Reg. 24128-24145 (1975).

⁷⁹ *Id.* 24137.

⁸⁰ *Id.* 24143-44.

⁸¹ *Id.* 24144. For proposed consolidated procedural regulations for Title IX and other civil rights laws see *id.* 24148.

⁸² *Id.* 24140.

⁸³ *Id.* 24140-43.

late directly to the treatment of students. The introductory and coverage sections will be examined only briefly.

A. Subparts A and B: Introduction and Coverage

The introduction to the regulations defines terms and explains when remedial and affirmative action and assurances of compliance are required.⁸⁴ Most of the section is a straightforward application of the statute. The coverage regulations also adhere closely to the statute and, therefore, are not a source of controversy. The coverage section establishes procedures to assure that the section 901(a)(3)⁸⁵ exemption for educational institutions of religious organizations is narrowly limited. If a religious institution wishes to claim that certain guidelines are inconsistent with its religious tenets, it must set forth in writing to the Director of the Office for Civil Rights the extent of the requested exemption and a copy of the religious tenets under which the exemption is claimed.⁸⁶

B. Subpart C: Admission and Recruitment

After a general prohibition of sex discrimination in admissions, Subpart C delineates specific prohibitions such as ranking separately on the basis of sex, and the use of quotas.⁸⁷ The use of separate rankings of male and female applicants as a means to enforce higher admissions standards for women has been attacked successfully under the rational basis test of the equal protection clause of the fourteenth amendment.⁸⁸ This is a blatant form of admissions discrimination and certainly violates Title IX. The quota system was specifically mentioned in the legislative history as a practice prohibited by the statute.⁸⁹

In language similar to that used by the Court in *Griggs*,⁹⁰ the regulations forbid the use of

any test or other criterion for admission which has a disproportionately adverse effect on persons on the

⁸⁴ *Id.* 24137-39.

⁸⁵ 20 U.S.C. § 1681(a)(3) (Supp. II, 1972).

⁸⁶ 40 Fed. Reg. 24139, § 86.12 (1975).

⁸⁷ *Id.* 24140, § 86.21(a), (b).

⁸⁸ In *Bray v. Lee*, 337 F. Supp. 934 (D. Mass. 1972), the Boston Latin School was forbidden to demand higher admission test scores from girls than from boys. *Berkelman v. San Francisco Unified School Dist.*, 501 F.2d 1264 (9th Cir. 1974), disallowed the same practice by a college preparatory high school.

⁸⁹ See, e.g., 118 CONG. REC. 5812 (1972) (remarks of Senator Beall).

⁹⁰ Text accompanying note 44 *supra*.

basis of sex unless the use of such test or criterion is shown to predict validly success in the education program or activity in question and alternative tests or criteria which do not have such a disproportionately adverse effect are shown to be unavailable.⁹¹

The regulations do not prohibit other practices neutral on their face but having a disparate impact on the protected class, such as restrictions on age or part-time attendance. The Women's Equity Action League and Representative Bella Abzug prepared a preliminary analysis of the regulations,⁹² recommending prohibition of such policies.⁹³ A broader attack on such procedures is within HEW's province and would increase the effectiveness of the regulations in eradicating all forms of sex discrimination in admissions.

Also forbidden in admissions procedures is any rule or policy concerning marital or parental status of students which operates to exclude members of one sex.⁹⁴ Pregnancy and related conditions are to be treated as any other temporary disability or physical condition.⁹⁵ According to the analysis suggested above, rules dealing with pregnancy should be considered within the regulatory power of HEW even though based on a physical characteristic unique to one sex.⁹⁶ The school must show educational necessity to justify different treatment of pregnant women. Such a showing probably cannot be made with respect to admissions policies that discriminate on the basis of marital or parental status.

Section 86.22 covers another method by which sex discrimination has been achieved in admissions. It prohibits schools from giving "preference to applicants for admission, on the basis of attendance at any educational institution . . . which admits as students predominantly members of one sex, if the giving of such preference has the effect of discriminating on the basis of

⁹¹ 40 Fed. Reg. 24140, § 86.21(b)(2) (1975).

⁹² WEAL-ABZUG PRELIMINARY ANALYSIS OF PROPOSED TITLE IX REGULATIONS, reprinted in 120 CONG. REC. E 4863-69 (daily ed. July 18, 1974).

⁹³ *Id.* 4865.

⁹⁴ 40 Fed. Reg. 24140, § 86.21(c) (1975). Perhaps enforcement of this regulation could be facilitated by providing that requests for information concerning marital or parental status cannot be included on applications for admission.

⁹⁵ *Id.* § 86.21(c)(3): "A recipient . . . shall treat disabilities related to pregnancy, childbirth, termination of pregnancy, or recovery therefrom in the same manner and under the same policies as any other temporary disability or physical condition . . ."

⁹⁶ See text accompanying notes 49-62 *supra*.

sex”⁹⁷ However, the introductory remarks put a gloss on the section.

Such preferences may be permissible . . . if the granting institution can show that the pool of applicants eligible for such preferences includes roughly equivalent numbers of males and females, or if it can show that the total number of applicants eligible to receive preferences is insignificant in comparison with its total applicant pool.⁹⁸

The subpart on admissions ends with a command that recruitment be directed equally to both sexes and a warning against primary or exclusive recruitment from single-sex or predominantly single-sex institutions.⁹⁹

C. *Subpart D: Programs and Activities*

1. Education Programs and Activities

Subpart D of the regulations, containing the substantive guidelines for treatment of students within the schools, is the principal focus of this Comment. It should be emphasized that the subpart D regulations apply to all educational institutions receiving federal financial assistance; the admissions exemptions stop once the student is accepted.¹⁰⁰ A general prohibition of discrimination under any “academic, extracurricular, research, occupational training, or other educational program or activity,” is followed by specific prohibitions.¹⁰¹ Neither aid, benefit, nor service can be denied, or given in a different manner or under a

⁹⁷ 40 Fed. Reg. 24140, § 86.22 (1975); *see id.* § 86.23(b).

⁹⁸ *Id.* 24130.

⁹⁹ *Id.* 24140, § 86.23.

¹⁰⁰ *See* text accompanying notes 9-12 *supra*.

¹⁰¹ 40 Fed. Reg. 24140-41, §§ 86.31(a), (b) (1975):

86.31 Education programs and activities.

(a) *General.* Except as provided elsewhere in this part, no person shall, on the basis of sex, be excluded from participation in, be denied the benefits of, or be subjected to discrimination under any academic, extracurricular, research, occupational training, or other education program or activity operated by a recipient which receives or benefits from Federal financial assistance. This subpart does not apply to actions of a recipient in connection with admission of its students to an education program or activity of (1) a recipient to which Subpart C does not apply, or (2) an entity, not a recipient, to which Subpart C would not apply if the entity were a recipient.

(b) *Specific prohibitions.* Except as provided in this subpart, in providing any aid, benefit, or service to a student, a recipient shall not, on the basis of sex:

(1) Treat one person differently from another in determining whether

different set of requirements, on the basis of sex.¹⁰² All clubs and service organizations conducted by the school must be open to women and men. Girls must be allowed to participate in such activities as safety patrol.¹⁰³ Recreational opportunities also must be equalized. The following practices are open to attack under these guidelines.

At one Ohio institution a woman could not use the handball courts unless a male signed up for her.

At a large midwestern university, the intramural pool was specifically reserved for "Faculty, Administrative Staff and Male Students" for approximately two hours each day. That is, this was a time for men only.¹⁰⁴

An educational institution may not on the basis of sex "[s]ubject any person to separate or different rules of behavior, sanctions or other treatment."¹⁰⁵ No longer may a school have different curfew requirements for women and men. Such regulations previously withstood equal protection challenges.¹⁰⁶

such person satisfies any requirement or condition for the provision of such aid, benefit, or service;

(2) Provide different aid, benefits, or services or provide aid, benefits, or services in a different manner;

(3) Deny any person any such aid, benefit, or service;

(4) Subject any person to separate or different rules of behavior, sanctions, or other treatment;

(5) Discriminate against any person in the application of any rules of appearance;

(6) Apply any rule concerning the domicile or residence of a student or applicant, including eligibility for in-state fees and tuition;

(7) Aid or perpetuate discrimination against any person by providing significant assistance to any agency, organization, or person which discriminates on the basis of sex in providing any aid, benefit or service to students or employees;

(8) Otherwise limit any person in the enjoyment of any right, privilege, advantage, or opportunity.

¹⁰² *Id.* §§ 86.31 (b)(1), (2), (3).

¹⁰³ For a discussion of recommended changes in this area and others, see K. DAVIDSON, R. GINSBURG & H. KAY, TEXT, CASES, AND MATERIALS ON SEX-BASED DISCRIMINATION (1974) [hereinafter cited as DAVIDSON].

¹⁰⁴ PROJECT ON THE STATUS AND EDUCATION OF WOMEN, WHAT CONSTITUTES EQUALITY FOR WOMEN IN SPORT? 5 (April, 1974).

¹⁰⁵ 40 Fed. Reg. 24141, § 86.31(b)(4) (1975).

¹⁰⁶ An attack on such a regulation under the equal protection clause failed in *Robinson v. Board of Regents*, 475 F.2d 707 (6th Cir. 1973), *cert. denied*, 416 U.S. 982 (1974), in which the Sixth Circuit found a rational relationship between the regulation and the State's legitimate safety objective. However, it is arguable that even under present equal protection standards, such a regulation should fall. Although the objective of protecting female students is commendable and to be encouraged, such a sweeping regulation goes beyond the *Reed* test of a "substantial relation to the object of the legislation." *Reed v. Reed*, 404 U.S. 71, 76 (1971). When a right as important as freedom of movement is at stake and the rule is so over-inclusive, the school should be required to pursue its

Also specifically forbidden is discrimination "in the application of any rules of appearance."¹⁰⁷ Presumably girls must now be allowed to wear pants, and boys must be permitted to wear their hair as long as they wish. It is difficult to know how much further the rule will or should go. In analogous Title VII litigation, courts have struck down differing rules for hair length but have sustained those for beards.¹⁰⁸ Since women cannot grow beards, they were considered a sex-specific characteristic and not within the purview of the statute. This Comment contends, however, that all "appearance" rules should be scrutinized under Title IX, but should be allowed to stand if educational necessity can be shown.¹⁰⁹ In defending due process challenges to dress codes¹¹⁰ schools have attempted to show that certain hair styles for men disrupt school activities. Courts have divided on this issue. Some have held that freedom to wear one's hair as one wishes is within the concept of liberty.¹¹¹ Others have either abstained¹¹² or sustained the regulation as a reasonable effort to maintain order in the schools that does not infringe any constitutional right.¹¹³ The regulation's general prohibition permits an appropriately flexible approach to evaluating school rules in this area.

A school may no longer apply any sex-differentiated domicile or residency rule in providing any aid, benefit, or service to a student.¹¹⁴ The Secretary's introductory remarks to the proposed regulations make clear that the Department is concerned in this area with eligibility for in-state tuition fees.

objective through more narrowly drawn means. Dormitory curfews are easier to implement than would be more narrowly drawn regulations, but administrative convenience should not save a classification based on sex. *See* *Frontiero v. Richardson*, 411 U.S. 677 (1973).

¹⁰⁷ 40 Fed. Reg. 24141, § 86.31(b)(5) (1975).

¹⁰⁸ *E.g.*, *Rafford v. Randle E. Ambulance Serv., Inc.*, 348 F. Supp. 316 (S.D. Fla. 1972).

¹⁰⁹ *See* text accompanying notes 49-62 *supra*.

¹¹⁰ *E.g.*, *Karr v. Schmidt*, 460 F.2d 609 (5th Cir. 1971), *cert. denied*, 409 U.S. 989 (1972); *King v. Saddleback Junior College Dist.* 445 F.2d 932 (9th Cir.), *cert. denied*, 404 U.S. 979 (1971); *Crews v. Cloncs*, 432 F.2d 1259 (7th Cir. 1970); *Richards v. Thurston*, 424 F.2d 1281 (1st Cir. 1970); *Press v. Pasadena Independent School Dist.*, 326 F. Supp. 550 (S.D. Tex. 1971); *Rumler v. Board of School Trustees*, 327 F. Supp. 729 (D.S.C. 1971).

¹¹¹ *Crews v. Cloncs*, 432 F.2d 1259 (7th Cir. 1970); *Richards v. Thurston*, 424 F.2d 1281 (1st Cir. 1970).

¹¹² *Press v. Pasadena Independent School Dist.*, 326 F. Supp. 550 (S.D. Tex. 1971).

¹¹³ *King v. Saddleback Junior College Dist.*, 445 F.2d 932 (9th Cir.), *cert. denied*, 404 U.S. 979 (1971); *Rumler v. Board of School Trustees*, 327 F. Supp. 729 (D.S.C. 1971).

¹¹⁴ 40 Fed. Reg. 24141, § 86.31(b)(6) (1975).

"[M]any educational institutions base their determinations of eligibility for in-state tuition on domicile; applicable state law may require a married woman to take the domicile of her husband as of the date of marriage, or further require a year of residency to demonstrate domicile."¹¹⁵ This kind of rule operates in favor of the female student attending school in her husband's domicile, but against the one whose school is located in her pre-marital domicile. Application of such a rule in either instance is now prohibited. HEW is clearly implementing the mandate of Title IX in this regard. A federal district court recently held that application of such a rule by Pennsylvania state universities violates the equal protection clause.¹¹⁶ The court was struck by the fact that there was "no rule . . . to tie the residency classification of any group other than married women to the classification of someone else."¹¹⁷

Section 86.31(b)(7)¹¹⁸ provides that a recipient of federal funds shall not "[a]id or perpetuate discrimination against any person by providing significant assistance to any agency, organization, or person which discriminates on the basis of sex in providing any aid, benefit, or service to students or employees"¹¹⁹ Sororities, fraternities, and youth service organizations such as the Girl Scouts and Boy Scouts successfully lobbied for the amendment exempting them from this provision.¹²⁰ The amendment may have been unnecessary under the proposed regulations, the introduction to which stated:

Among the criteria to be considered in each case are the substantiality of the relationship between the recipient subject to the regulation and the other party involved, including the financial support by the recipient, and whether the other party's activities relate so closely to the recipient's educational program or activity, or to students or employees in that program, that they fairly should be considered as activities of the recipient itself.¹²¹

¹¹⁵ 39 Fed. Reg. 22229 (1974).

¹¹⁶ *Samuel v. University of Pittsburgh*, 375 F. Supp. 1119 (W.D. Pa.), *appeal dismissed*, 506 F.2d 355 (3d Cir. 1974).

¹¹⁷ *Id.* at 1131.

¹¹⁸ 40 Fed. Reg. 24141, § 86.31(b)(7) (1975). This section was severely criticized in the letters received by HEW after the announcement of the proposed regulations. N.Y. Times, Nov. 25, 1974, at 23, col. 3.

¹¹⁹ 40 Fed. Reg. 24141, § 86.31(b)(7) (1975).

¹²⁰ See text accompanying notes 21-30 *supra*.

¹²¹ 39 Fed. Reg. 22229 (1974).

In explaining the final regulations, HEW writes, "[s]uch forms of assistance to discriminatory groups as faculty sponsors, facilities, administrative staff, etc., may be significant enough to render the organization subject to the . . . regulation."¹²² The use of school facilities will involve the most difficult determinations. HEW's approach in the final regulations¹²³ can be criticized for allowing any use of school facilities by sex-restricted organizations. The language of Title IX is absolute. The right of privacy is not at issue. Use of facilities is not restricted to discriminatory organizations whose "discrimination" might be justified by educational necessity.¹²⁴ Under the approach taken in this Comment the discrimination potentially tolerated by this section cannot be justified.

The WEAL-Abzug report correctly points out that the language of section 86.31(b)(7) prohibits recipients from assisting only those organizations that provide a benefit or service to students.¹²⁵ Such single-sex organizations as the Junior Chamber of Commerce and Little League (while it remained single sex), which fall outside that qualification, could take advantage of school property and services without the intervention of HEW.¹²⁶ Such a loophole in the regulations is in conflict with the broad construction of the statute suggested by *Griggs* and *Lau*.

Section 86.31 ends with the regulation of programs not operated by the recipient in which students or employees of the recipient are required or permitted to participate, including "educational consortia and cooperative employment and student-teaching assignments."¹²⁷ The recipient must develop a procedure to ensure that the operator of the program takes no action in regard to students or employees which the recipient would be forbidden to take.¹²⁸ If the recipient cannot ensure non-discrimination by the operator, it must dissociate itself from the program.¹²⁹ This is a commendable attempt by the Department to reach less direct but nonetheless destructive discrimination encountered by women in education.

¹²² HEW FACT SHEET 7 (June, 1975).

¹²³ Text accompanying note 122 *supra*.

¹²⁴ See text accompanying notes 44-62 *supra*.

¹²⁵ WEAL-ABZUG PRELIMINARY ANALYSIS OF PROPOSED TITLE IX REGULATIONS, reprinted in 120 CONG. REC. E 4866 (daily ed. July 18, 1974).

¹²⁶ *Id.*

¹²⁷ 40 Fed. Reg. 24141, § 86.31(d)(1) (1975).

¹²⁸ *Id.* § 86.31(d)(2)(i).

¹²⁹ *Id.* § 86.31(d)(2)(ii).

2. Housing and Other Facilities

The housing regulations are a straightforward implementation of section 907, which allows schools to maintain separate living facilities for the sexes.¹³⁰ The separate housing for females and males must be proportionate in quantity and quality,¹³¹ governed by non-discriminatory rules, and subject to the same fees.¹³² If the institution is involved in any way in off campus housing, it must take reasonable action to assure itself that such housing of equal quantity, quality, and cost is available to women and to men.¹³³ The next section permits separate but comparable toilet, locker room, and shower facilities on the basis of sex.¹³⁴ This interpretation comports with the rationale underlying the living facilities exception.¹³⁵

3. Integration of Courses

The provision for equal access to educational programs or activities is controversial. "A recipient shall not provide any course or otherwise carry out any of its education program or activity separately on the basis of sex, . . . including health, physical education, industrial, business, vocational, technical, home economics, music, and adult education courses."¹³⁶ The two most heatedly discussed aspects of this regulation are the possible integration of sex education and physical education classes.¹³⁷ Sex education classes were specifically exempted in July, 1974,¹³⁸ but gym classes must be integrated.

It is difficult to reconcile the sex education exemption with a general rejection of the separate-but-equal doctrine.¹³⁹ It might be argued that the right of privacy justifies this exemption. However, discussion of sexual matters is far different from the type of sexual activity protected by *Griswold* and *Roe*.¹⁴⁰ Neither

¹³⁰ 20 U.S.C. § 1686 (Supp. II, 1972).

¹³¹ 40 Fed. Reg. 24141, § 86.32(b) (1975).

¹³² *Id.* § 86.32(a).

¹³³ *Id.* § 86.32(c).

¹³⁴ *Id.* § 86.33.

¹³⁵ See text accompanying notes 32-37 *supra*.

¹³⁶ 40 Fed. Reg. 24141, § 86.34 (1975).

¹³⁷ The following letter was received during the comment period on the subject of the integration of physical education classes: "The morals of this nation are low enough now. Please don't make it worse. I pray the time will soon come again when men can be men and women can be women and each proud of what God made them." N.Y. Times, Nov. 25, 1974, at 23, col. 5 (city ed.).

¹³⁸ *Id.*; 40 Fed. Reg. 24141, § 86.34(e) (1975).

¹³⁹ See text accompanying notes 63-77 *supra*.

¹⁴⁰ See text accompanying notes 32-37 *supra*.

can the concept of "unique physical characteristics" justify separate sex education classes.¹⁴¹ Nevertheless, HEW's toleration of separate sex education classes probably will not be challenged. According to HEW, the tentative existence of sex education classes would be threatened by a forced integration.¹⁴²

Integration of physical education classes is required, despite a hostile reaction to the proposed regulations and a move in the House for a physical education exemption.¹⁴³ There should be no question that separate and unequal physical education programs would violate Title IX. The Project on the Status and Education of Women has compiled examples of how sex discrimination is manifested in this area.

At a prestigious private institution the women's and men's physical education departments were separate and the instructional courses available to female and male students varied considerably. For example, women could not take wrestling and men could not take self defense or volleyball.

At a southern state university female students could not take coaching courses for credit, with the result that they were not "qualified" to coach teams.

At an Ohio liberal arts college women majoring in physical education must take a service course each term. There is no similar requirement for men.

At a Pennsylvania college women must show proficiency in two sports in order to graduate. Men need only to show proficiency in one sport.¹⁴⁴

These examples of different treatment accorded male and female students are prohibited by the regulations.¹⁴⁵

Separate-but-equal physical education programs should also

¹⁴¹ See Brown, *supra* note 29, at 893-96.

¹⁴² Action Memorandum from Director of Office for Civil Rights to Secretary of HEW, June 12, 1973, *quoted in* Davidson, *supra* note 103, at 847.

¹⁴³ In November, a Conference Report on H.R. 15580, making appropriations for the departments of Labor and HEW, attempted to make legislative history for Title IX to forestall HEW action in this area. Representative Edith Green expressed the position of the report: "[It] has just [been] called to my attention that one of the proposed regulations was that all physical education classes had to be integrated. Title IX was never designed to have the Federal Government get into the internal operations of how to run the classes in each and every school in the country . . ." 120 CONG. REC. 11106 (daily ed. Nov. 26, 1974).

¹⁴⁴ PROJECT ON THE STATUS AND EDUCATION OF WOMEN, *supra* note 104, at 4-5.

¹⁴⁵ 40 Fed. Reg. 24141, § 86.34 (1975).

be unacceptable. It was suggested above that separate-but-equal is permissible only within the narrow privacy exception or when necessary to assure equal opportunities for women.¹⁴⁶ The exemption for separate locker facilities takes care of any disrobing problem.¹⁴⁷ The arguments for separation that have force in competitive athletics where ability is the criterion for participation¹⁴⁸ are not applicable here, since students of all abilities are included in physical education classes. This is an area where the risks of inequality are great. Separate treatment discourages serious athletic interests of women and perpetuates expectations of low athletic achievement and denigration by women of their own physical abilities.¹⁴⁹

Business and vocational classes, especially home economics and shop, are often sex segregated. No longer may a school offer separate cooking classes where girls are taught to be homemakers and boys to be chefs.¹⁵⁰ In this area also, requirements for graduation have differed. In *Robinson v. Washington*,¹⁵¹ a female student challenged a state board of education regulation requiring one unit of home economics for girls, but not for boys, as a prerequisite to graduation. In denying the plaintiff's request for a three judge court, the judge articulated the "judicial perspective"¹⁵² from which the pursuit of sexual equality has often been viewed: "[A] judge who enjoys food is hard put to make a decision in this type of a case. Perhaps he wears his prejudice on his sleeve or in the area of his belt."¹⁵³

4. Appraisal and Counseling Materials

Some of the more subtle and destructive sex discrimination in education takes place in the area of counseling.¹⁵⁴ The effect

¹⁴⁶ See text accompanying notes 63-77 *supra*.

¹⁴⁷ 40 Fed. Reg. 24141, § 86.33 (1975).

¹⁴⁸ See text accompanying notes 75-76 *supra* and notes 207-19 *infra*.

¹⁴⁹ See Fasteau, *Giving Women a Sporting Chance*, Ms., July, 1973, at 56.

"The physically inferior, it turns out, are not women, but any human beings who do not develop the body's potential—exactly what women have been taught not to do for centuries. Just how much that indoctrination has cost them is only now being revealed, as more and more girls challenge the age-old prejudices defining their physical capacities."

Scott, *Closing the Muscle Gap*, Ms., Sept., 1974, at 49.

¹⁵⁰ But see 120 CONG. REC. 11106-07 (daily ed. Nov. 26, 1974) (remarks of Representative Green).

¹⁵¹ Civil No. 9576 (W.D. Wash., filed Mar. 22, 1971).

¹⁵² See Johnston & Knapp, *Sex Discrimination by Law: A Study in Judicial Perspective*, 46 N.Y.U.L. REV. 675 (1971).

¹⁵³ WOMEN'S RIGHTS L. REP., Spring, 1972, at 42.

¹⁵⁴ See 1970 *Hearings*, *supra* note 2, at 501-10, 435-50, 314-15.

on a young girl of a counselor's saying that a given career is inappropriate for her can be irreversible. The results of a vocational guidance test that has been color coded "pink" to direct female students into careers such as homemaker, nurse, actress, and model, can determine the career choice of a potential scientist. During the hearings on discrimination against women, academicians working in this field painted a very dark picture of a girl's chances of getting adequate career guidance.¹⁵⁵ "[T]here is some evidence, a small but growing body of research and investigation, that the individual counselor reflects—and his attitudes may even be reinforced by current training programs—the prejudices and biases of the larger society relating to woman and her educational/vocational choices."¹⁵⁶

The proposed regulations would have changed only the most blatant discriminatory practices. A school would not have been able to use different materials for the two sexes, and tests that require or permit different treatment of students on the basis of sex would have been prohibited.¹⁵⁷ The final regulations have been extended to prohibit discriminatory counseling itself. Because discriminatory counseling can be difficult to detect, especially by the counselors, schools are required to reexamine counseling when a single sex predominates in any particular class or program.¹⁵⁸

¹⁵⁵ *Id.*

¹⁵⁶ *Id.* 507.

¹⁵⁷ 39 Fed. Reg. 22228, § 86.34(c) (1974).

¹⁵⁸ 40 Fed. Reg. 24141-42, § 86.36 (1975):

(a) *Counseling.* A recipient shall not discriminate against any person on the basis of sex in the counseling or guidance of students or applicants for admission.

(b) *Use of appraisal and counseling materials.* A recipient which uses testing or other materials for appraising or counseling students shall not use different materials for students on the basis of their sex or use materials which permit or require different treatment of students on such basis unless such different materials cover the same occupations and interest areas and the use of such different materials is shown to be essential to eliminate sex bias. Recipients shall develop and use internal procedures for ensuring that such materials do not discriminate on the basis of sex. Where the use of a counseling test or other instrument results in a substantially disproportionate number of members of one sex in any particular course of study or classification, the recipient shall take such action as is necessary to assure itself that such disproportion is not the result of discrimination in the instrument or its application.

(c) *Disproportion in classes.* Where a recipient finds that a particular class contains a substantially disproportionate number of individuals of one sex, the recipient shall take such action as is necessary to assure itself that such disproportion is not the result of discrimination on the basis of sex in counseling or appraisal materials or by counselors.

Since the human element is so crucial in this area, educational institutions should probably have been required to conduct training sessions for their counselors to make them more sensitive to the necessity of approaching female students with the same open-ended career suggestions offered to males.¹⁵⁹ Alice Fins, of the American Personnel and Guidance Association, focused the problem when relating the reaction of counselors to women with strong career ambitions: "You'll be getting married soon. Why this?"¹⁶⁰ No matter how neutral the materials, reinforcement of sexual stereotypes cannot be eradicated when enforcement of the regulations rests solely in the same school officials who are often unaware of their own discriminatory outlook.

5. Financial and Employment Assistance

The only exceptions to a complete prohibition of different treatment in the area of financial assistance relate to athletics¹⁶¹ and to foreign wills, trusts, or provisions by a foreign government.¹⁶² The most obvious scholarship suggested by the foreign will exemption is the prestigious Rhodes Scholarship. The only justification offered for the exemption is that the Secretary does not think the statute was intended to cover such programs.¹⁶³ No theoretical reason justifies this assumption. Title VI contains no such exception.¹⁶⁴ It is anomalous to allow one of the most coveted rewards for excellence to be denied a student on the basis of sex. Harvard and several other institutions have already nominated women who have been rejected solely on account of sex.¹⁶⁵ Title IX does not permit such an exception to its mandate of equality.

There are no apparent loopholes in the employment guidelines. An educational institution which itself employs stu-

¹⁵⁹ See 1970 Hearings, *supra* note 2, at 501-10.

¹⁶⁰ Philadelphia Inquirer, Sept. 1, 1974, at 4, col. 5.

¹⁶¹ 40 Fed. Reg. 24142, § 86.37(c) (1975):

(1) To the extent that a recipient awards athletic scholarships or grants-in-aid, it must provide reasonable opportunities for such awards for members of each sex in proportion to the number of students of each sex participating in interscholastic or intercollegiate athletics.

(2) Separate athletic scholarships or grants-in-aid for members of each sex may be provided as part of separate athletic teams for members of each sex to the extent consistent with this paragraph and § 86.41 of this part.

¹⁶² *Id.* § 86.37(b).

¹⁶³ Statement by Caspar Weinberger, Secretary of HEW, HEW NEWS, June 3, 1975, at 3.

¹⁶⁴ 45 C.F.R. § 80.3(b)(1)-(iii) (1970).

¹⁶⁵ WEAL-ABZUG PRELIMINARY ANALYSIS OF PROPOSED TITLE IX REGULATIONS, *re-printed in* 120 CONG. REC. E 4866 (daily ed. July 18, 1974).

dents must do so in a nondiscriminatory manner.¹⁶⁶ If an agency, organization, or person is assisted by a recipient in making employment available to students, the recipient must assure that such employment is available to both sexes.¹⁶⁷ If assurances are not forthcoming, the recipient may not assist the organization.¹⁶⁸ Health and insurance benefits and services also must be provided equally for both sexes.¹⁶⁹

6. Marital or Parental Status

Section 86.40(a) prohibits the application by recipients of "any rule concerning a student's actual or potential parental, family, or marital status which treats students differently on the basis of sex."¹⁷⁰ The regulation goes on to provide that recipients may not exclude pregnant students from their education programs or activities "unless the student requests voluntarily to participate in a separate portion of the program or activity. . . ."¹⁷¹ A recipient may, however, require a pregnant student who desires to remain in the regular program

to obtain the certification of a physician that the student is physically and emotionally able to continue participation in the normal education program or activity so long as such a certification is required of all students for other physical or emotional conditions requiring the attention of a physician.¹⁷²

If a recipient operates a separate program for pregnant students, it must be comparable with the regular program.¹⁷³ Any disability related to pregnancy or recovery therefrom must be treated in the same manner as any other temporary disability with respect to student medical benefits, and pregnancy must be treated as a justification for a leave of absence for a period deemed medically necessary by the student's doctor, "at the conclusion of which the student shall be reinstated to the status which she held when the leave began."¹⁷⁴

Although it was suggested above that pregnancy-based clas-

¹⁶⁶ 40 Fed. Reg. 24142, § 86.38(b) (1975).

¹⁶⁷ *Id.* § 86.38(a).

¹⁶⁸ *Id.*

¹⁶⁹ *Id.* § 86.39.

¹⁷⁰ *Id.* § 86.40(a).

¹⁷¹ *Id.* § 86.40(b)(1).

¹⁷² *Id.* § 86.40(b)(2).

¹⁷³ *Id.* § 86.40(b)(3).

¹⁷⁴ *Id.* §§ 86.40(b)(4), (5).

sifications are not absolutely prohibited by Title IX and might be justified by a showing of educational necessity,¹⁷⁵ HEW has determined that exclusion or separation can be justified only under the specific conditions stated in the regulations. The Department's judgment, if challenged, will be given great deference by the courts;¹⁷⁶ and its judgment seems sound. The expulsion of pregnant teenagers from schools is a serious problem. A 1972 HEW report comments on the policy:

Every year over 200,000 young women under 18 give birth. Usually these young women are expelled from school at the first sign of pregnancy. Out of 17,000 school districts surveyed in 1970, fewer than one third offered pregnant school-age girls any education at all. School districts that did allow students to study during pregnancy usually kept them at home or segregated them in special classes for various reasons—on moral grounds, for special protection or for convenience.

.....
Expulsion compounds the already serious problems of teenage pregnancy. Of every 100 pregnant teenagers who leave school, 85 never come back. Rejected, cast out with a child to support and often no salable skills, these teenagers are nine times more likely to commit suicide than their peers.¹⁷⁷

In *Ordway v. Hargraves*,¹⁷⁸ a federal district court ordered a high school to admit a pregnant student to all classes. Medical testimony was offered to show that the student herself would be in no physical danger in attending school; on the contrary, there was a possibility of mental depression if excluded.¹⁷⁹ The plaintiff had not disrupted school activity in any way, and the court failed to find an educational purpose for the policy.¹⁸⁰ The principal suggested that the policy might have developed from a desire of the school officials not to appear to condone, and thus possibly increase the incidence of, pre-marital pregnancy.¹⁸¹ The validity of such moral censorship is open to serious question on first amendment grounds, but even if constitutionally permissi-

¹⁷⁵ See text accompanying notes 49-62 *supra*.

¹⁷⁶ Cf. *Griggs v. Duke Power Co.*, 401 U.S. 424, 433-34 (1971).

¹⁷⁷ DAVIDSON, *supra* note 103, at 867.

¹⁷⁸ 323 F. Supp. 1155 (D. Mass. 1971).

¹⁷⁹ *Id.* at 1156-57.

¹⁸⁰ *Id.* at 1157.

¹⁸¹ *Id.* at 1158.

ble, the likelihood of the feared effects is too remote to justify exclusion.

The two exceptions to the general prohibition against exclusion of pregnant students—student request and physician certification—can be justified. Since the well-being of the student should be the primary objective of educational institutions, a student's desire to separate herself from her peers during her pregnancy should be honored. A physician's judgment of medical necessity seems also to justify exclusion on this rationale, where a doctor's certificate is required of all students with other physical or emotional conditions necessitating medical attention. This general requirement prevents stigmatization of the excluded pregnant student.

7. Competitive Athletics

Not to have confidence in one's body is to lose confidence in oneself It is precisely the female athletes, who being positively interested in their own game, feel themselves least handicapped in comparison with the male. Let her swim, climb mountain peaks, pilot an airplane, battle against the elements, take risks, go out for adventure, and she will not feel before the world that timidity.

—Simone de Beauvoir.¹⁸²

Probably the most controversial HEW regulations are those involving equalization of opportunities for men and women in the area of competitive athletics.¹⁸³ Athletic associations around the country complained of the impossibility of complying with the proposed athletic regulations,¹⁸⁴ claiming that the regulations would destroy collegiate athletics as it is known today. Such pressure exerted on HEW resulted in the weak athletic section of the final regulations.

The general prohibition of different treatment according to sex in any interscholastic, intercollegiate, club or intramural athletics¹⁸⁵ is significantly undermined by section 86.41(b).¹⁸⁶ Whenever the activity involved is a "contact sport," the educational institution may operate separate single-sex teams, whether

¹⁸² Loggia, *On the Playing Fields of History*, Ms., July, 1973, at 64.

¹⁸³ 40 Fed. Reg. 24142, § 86.41 (1975).

¹⁸⁴ See Comments to the Proposed HEW Regulations, on file with the Region III Director of the Office for Civil Rights, 3535 Market St., Philadelphia, Pa. 19101.

¹⁸⁵ 40 Fed. Reg. 24142, § 86.41(a) (1975).

¹⁸⁶ *Id.* § 86.41(b).

on an intramural or competitive level.¹⁸⁷ Where non-contact sports are involved and selection for a team is based on competitive skill, separate teams are also allowed.¹⁸⁸ If, however, a school fields only one team in a non-contact sport, the excluded sex must be permitted to try out for the single team if athletic opportunity for the excluded sex has previously been limited.¹⁸⁹ The only check on the discrimination permitted by this section is the general requirement that the schools provide equal athletic opportunity for members of both sexes. The regulation lists various factors relevant to a determination of the required equality of opportunity, including unequal aggregate expenditures for male and female teams.¹⁹⁰

One threshold contention of the National Collegiate Athletic Association [NCAA] is that according to the language of the statute, sports programs should not be covered at all unless they receive direct federal funding.¹⁹¹ The statute provides, "[T]ermination of or refusal to grant or to continue assistance . . . shall be limited in its effect to the particular program, or part thereof, in which . . . noncompliance has been . . . found" ¹⁹² The NCAA argues that funds cannot be refused other programs and activities in a school because of the athletic department's

¹⁸⁷ *Id.*

¹⁸⁸ *Id.*

¹⁸⁹ *Id.*

¹⁹⁰ 40 Fed. Reg. 24142, § 86.41(c) (1975):

(c) *Equal opportunity.* A recipient which operates or sponsors interscholastic, intercollegiate, club or intramural athletics shall provide equal athletic opportunity for members of both sexes. In determining whether equal opportunities are available the Director will consider, among other factors:

(i) Whether the selection of sports and levels of competition effectively accommodate the interests and abilities of members of both sexes;

(ii) The provision of equipment and supplies;

(iii) Scheduling of games and practice time;

(iv) Travel and per diem allowance;

(v) Opportunity to receive coaching and academic tutoring;

(vi) Assignment and compensation of coaches and tutors;

(vii) Provision of locker rooms, practice and competitive facilities;

(viii) Provision of medical and training facilities and services;

(ix) Provision of housing and dining facilities and services;

(x) Publicity.

Unequal aggregate expenditures for members of each sex or unequal expenditures for male and female teams if a recipient operates or sponsors separate teams will not constitute noncompliance with this section, but the Director may consider the failure to provide necessary funds for teams for one sex in assessing equality of opportunity for members of each sex.

¹⁹¹ Statement of the NCAA on Title IX Implementation Regulations, June 26, 1974, on file with the Director of the Office for Civil Rights of Region III, 3535 Market St., Philadelphia, Pa. 19101; N.Y. Times, Nov. 25, 1974, at 23, col. 4 (city ed.).

¹⁹² 20 U.S.C. § 1682 (Supp. II, 1972).

discrimination, since the discrimination must exist in the specific program being cut off.¹⁹³ Such a reading of the statute is plausible,¹⁹⁴ but HEW takes a broader view. The Department subjects any program or activity to its requirements "if it receives or *benefits from* such assistance."¹⁹⁵

Another theory through which some organizations hope to escape the statute is that revenue-producing sports should be exempted from Title IX. Congresswoman Green reads an exemption into the statute for "intercollegiate sports financed by gate receipts . . ."¹⁹⁶ Representative Abzug, however, warned that "making a differentiation as to the source of funds could result in unequal benefits. Thus a man's basketball team . . . could continue to travel in first-class planes while the women's basketball team . . . would have to sell cookies to pay for their transportation."¹⁹⁷ Although there is certainly a difference between activities supported by tuition, fees, or tax dollars and those financed by gate receipts, HEW does not exempt the latter from the general prohibition against sex discrimination. It also seems improbable that many sports would fit into such an exemption since account would have to be taken of the funds that may be "hidden" in the institution's budget in a number of ways—maintenance on the stadium, practice gyms and fields;

¹⁹³ Some of the stronger protests, notably by the NCAA, have provoked congressional reaction to the new regulations. On July 8, 1975, H.R. 8395 was introduced, a measure that "would allow revenue-producing sports to use their profits to maintain their own teams before diverting any profits to other men's teams and women's teams." 33 CONG. Q. WEEKLY REPT. 1484 (July 12, 1975). For further discussion of congressional efforts to block or amend the athletics regulations, see *id.* 1484-85. As of this writing H.R. 8395 was tentatively scheduled for hearings in September, 1975. *Id.* 1672 (Aug. 2, 1975).

¹⁹⁴ See DAVIDSON, *supra* note 103, at 872: "Unlike Title IX of the Education Amendments of 1972, which provides for sanctions limited to the noncomplying unit or program, Executive Order sanctions may be directed at the university or college as a whole."

¹⁹⁵ 40 Fed. Reg. 24128 (1975) (introductory material) (emphasis supplied). Both HEW and NCAA rely for their interpretations on *Board of Public Instruction v. Finch*, 414 F.2d 1068 (5th Cir. 1969). This case construes parallel language of Title VI, 42 U.S.C. § 2000d-1 (1970), which provides: "[T]ermination or refusal . . . shall be limited in its effect to the particular program, or part thereof, in which . . . noncompliance has been . . . found"

The court called for individualized consideration of the use of funds of each grant statute but noted that a program may be "so affected by discriminatory practices elsewhere in the school system that it thereby becomes discriminatory." 414 F.2d at 1079. Athletic departments may be able to argue that they have not infected the environment sufficiently to cause other programs to lose funding; the burden, however, should at least be on the recipient to demonstrate the lack of effect on other programs.

¹⁹⁶ 120 CONG. REC. 11107 (daily ed. Nov. 26, 1974) (remarks of Representative Green).

¹⁹⁷ *Id.* 11108; see PROJECT ON THE STATUS AND EDUCATION OF WOMEN, *supra* note 104, at 13.

health care provided by the university health service; salaries of coaches or trainers"; athletic scholarships, etc.¹⁹⁸

One highly questionable provision is section 86.41(c):

Unequal aggregate expenditures for members of each sex or unequal expenditures for male and female teams if a recipient operates or sponsors separate teams will not constitute noncompliance with this section, but the Director may consider the failure to provide necessary funds for teams for one sex in assessing equality of opportunity for members of each sex.¹⁹⁹

One might argue that the decision not to require equal aggregate expenditures is justified, because even after opportunities are equalized fewer girls will participate in competitive athletics than boys. Also some sports are more expensive to equip than others. If one sex predominates on such teams, total expenditures will be unequal. However, if the assumption is that girls are not as interested as boys and will not come out for competitive athletics in the same numbers, one must look to the reasons for this lack of interest. One major reason must be past discrimination. If all through school girls have had no training, no access to gyms and equipment, no "encouragement" to participate, it is hardly a justification for unequal expenditures that at the age of sixteen they are not as interested in sports as are boys.²⁰⁰

Without an equal expenditure requirement it is difficult to see how HEW will evaluate the equality of sports programs. The warning has come that an equal expenditure approach would change the face of intercollegiate athletics.²⁰¹ But that is just the purpose of Title IX—to prevent the tuition, fees, and tax dollars of women students and taxpayers from being used to benefit only men. It is true that resources are finite; Title IX does not mandate spending money that does not exist. But it does demand spending available funds without discrimination on the basis of sex. Surely the Supreme Court's decision in *Lau v. Nichols*²⁰² cost the San Francisco Unified School District some money. And *Brown v. Board of Education*²⁰³ changed the face of

¹⁹⁸ PROJECT ON THE STATUS AND EDUCATION OF WOMEN, *supra* note 104, at 13; see Dunkle, *College Athletics: Tug-of-War for the Purse Strings*, Ms., Sept., 1974, at 114.

¹⁹⁹ 40 Fed. Reg. 24143, § 86.41(c) (1975).

²⁰⁰ See Fasteau, *supra* note 149, at 57.

²⁰¹ See Comments to the Proposed HEW Regulations, on file with the Region III Director of the Office for Civil Rights, 3535 Market St., Philadelphia, Pa. 19101.

²⁰² 414 U.S. 563 (1974).

²⁰³ 347 U.S. 483 (1954).

education in the South. If such be the result of implementing the will of Congress, educators and athletic organizations must face that reality, and proceed forthwith to reevaluate the use of their resources with the goal in mind of developing the physical well-being of female and male students.

Questions about the applicability of the separate-but-equal doctrine inevitably arise in this area. The regulations allow:

separate teams for members of each sex where selection for such teams is based upon competitive skill or the activity involved is a contact sport. However, where a recipient operates or sponsors a team in a particular sport for members of one sex but operates or sponsors no such team for members of the other sex, and athletic opportunities for members of that sex have previously been limited, members of the excluded sex must be allowed to try-out for the team offered unless the sport involved is a contact sport. For the purposes of this part, contact sports include boxing, wrestling, rugby, ice hockey, football, basketball and other sports the purpose of [sic] major activity of which involves bodily contact.²⁰⁴

Earlier it was argued that under Title IX there should be only two justifications for separate treatment based on sex: to implement the explicit, narrow living facilities exception, or to assure equal access to certain activities.²⁰⁵ The narrow construction of the living facilities exception discussed earlier in the Comment does not justify separate treatment in the context of competitive athletics beyond the provision of separate locker room facilities.²⁰⁶ Thus, only separation necessary to assure equal access for women can be justified.

The acceptability under Title IX of fielding separate male and female teams in a particular sport should depend on the age

²⁰⁴ 40 Fed. Reg. 24142-43, § 86.41(b) (1975). HEW explains:

Where selection is based on *competitive skill* or the activity involved is a *contact* sport, athletics may be provided through *separate* teams for males and females or through a single team open to both sexes. If separate teams are offered, a recipient institution may not discriminate on the basis of sex in provision of necessary equipment or supplies, or in any other way, *but equal aggregate expenditures are not required*. The goal of the final regulation in the area of athletics is to secure equal opportunity for males and females while allowing schools and colleges flexibility in determining how best to provide such opportunity.

HEW, Fact Sheet 6 (June, 1975).

²⁰⁵ Text accompanying notes 74-77 *supra*.

²⁰⁶ See text accompanying notes 32-37 *supra*.

level of the students involved. It might be argued that there are sufficient physiological differences between the sexes not only to justify but to mandate separate-but-equal in this context. Where boys are physically stronger and larger than girls, *Lau* and *Griggs* alert us to the danger of impermissible de facto exclusion of girls from teams selected on the basis of competitive skill.²⁰⁷ In such a situation separate teams might be not merely acceptable, but mandatory, to prevent unequal access to competitive athletic activities.²⁰⁸

A full medical evaluation of the physical differences between men and women is well beyond the scope of this Comment. Yet some discussion of those differences is necessary to set standards for deciding when Title IX permits separate teams for girls and boys. Whatever the physical differences between girls and boys, they clearly increase as children get older.

[T]hroughout childhood, boys and girls are roughly similar in size, strength, and reaction times. Girls aged 9 to 12 are, if anything, larger and stronger than their male peers because their bone structure and musculature begin developing earlier and mature by age 12 or 13. Boys do not generally achieve the same stage of development until age 14, 15, or 16.²⁰⁹

Medical evidence to this effect convinced the New Jersey Supreme Court to uphold a finding by the New Jersey Division on Civil Rights that girls of eight to twelve are not as a class subject to greater hazard of injury than boys and therefore must be allowed to play Little League baseball.²¹⁰ It appears, then, that medical evidence does not justify athletic separation of the sexes before the junior high school level.²¹¹ If before junior high school some sports end up being predominantly of one sex because of personal preferences, there would be no violation of Title IX. But mandatory separation of the sexes in sports should not be allowed below the junior high school level unless substantial evidence indicates that failure to maintain separate teams

²⁰⁷ See text accompanying notes 75-76 *supra*.

²⁰⁸ See Fasteau, *supra* note 149, at 103. For analyses of the constitutional adjudication in this area and possible ways to eradicate sex discrimination in athletics, see Comment, *Equality in Athletics: the Cheerleader v. the Athlete*, 19 S.D.L. REV. 428 (1974); Comment, *Sex Discrimination in Interscholastic High School Athletics*, 25 SYRACUSE L. REV. 535 (1974).

²⁰⁹ Scott, *supra* note 149, at 50.

²¹⁰ NOW, *Essex County Chapter v. Little League Baseball, Inc.*, 127 N.J. Super. 522, 318 A.2d 33 (1974).

²¹¹ Fasteau, *supra* note 149, at 58.

will, because of physical differences, result in the de facto exclusion of girls from the particular competitive sport in question.

At adolescence, physical differences increase and might well support the conclusion that separate teams should be permitted lest girls receive less benefits than boys. "[Y]oung men are on the average about 10 percent larger than young women, and their muscle mass is about twice that of girls. They perform two to four times as well in test of strength" ²¹² These differences should not be overemphasized. "Evidence shows that the difference in strength between trained male and female athletes is far less than that between average or untrained men and women." ²¹³ Nevertheless, at present the gross disparity in training and conditioning and the undeniable physical differences between the sexes allow separate teams beginning at the junior high school level. The regulations, of course, permit them at every level. ²¹⁴

The regulations do not, however, require separate teams at any level. If a school maintains a single team in a non-contact sport without providing a separate female team in the sport, women must be permitted to try out for that single team. ²¹⁵ The regulations do not imply that a single, non-contact-sport team for which women may try out per se satisfies the requirements of section 86.41. ²¹⁶ If under an open tryout system interested women are in fact excluded, the single team arrangement may not satisfy the "equal opportunity" requirements of section 86.41(c). ²¹⁷ This interpretation is consistent with the general

²¹² Scott, *supra* note 149, at 50.

²¹³ *Id.* 49. Women are catching up to men in international competitions such as track and swimming. At the 1924 Olympic games, men's time in the 400-meter freestyle was 16 percent faster than women's; 11.66 percent faster in 1948; and only 7.3 percent faster in 1972 at Munich. *Id.*

²¹⁴ 40 Fed. Reg. 24142, § 86.41(b) (1975).

²¹⁵ Many young women have obtained injunctions to force their schools and athletic associations to allow them to try out for non-contact sports for which there was no girls' team. *Brenden v. Independent School Dist.*, 477 F.2d 1292 (8th Cir. 1973); *Reed v. Nebraska School Activities Ass'n*, 341 F. Supp. 258 (D. Neb. 1972); *Haas v. South Bend Community School Corp.*, 289 N.E.2d 495 (Ind. 1972). *Contra Bucha v. Illinois High School Ass'n*, 351 F. Supp. 69 (N.D. Ill. 1972). The complaints generally charged violation of fourteenth amendment rights to equal protection. In *Brenden* the Eighth Circuit examined the interest of the student in competing in interscholastic athletics and that of the high school in assuring that persons with similar qualifications compete among themselves, and found no "sufficient rational basis for concluding that women are incapable of competing with men in non-contact sports." 477 F.2d at 1300.

²¹⁶ See Statement of Caspar Weinberger, Secretary of HEW, HEW News, June 3, 1975, at 4.

²¹⁷ 40 Fed. Reg. 24142, § 86.41(c) (1975).

principles suggested earlier.²¹⁸ Thus, if teams theoretically open to all on a competitive basis result in exclusion of women from athletic participation, separate teams for women may be required by the regulation and are certainly required by the statute itself.²¹⁹

The general framework developed earlier²²⁰ indicates that separate contact-sport teams are justifiable in no more situations than are separate teams for non-contact sports. It might be argued that privacy should justify separating boys and girls in contact sports. As noted earlier, however, the living facilities exception does not extend this far.²²¹

Safety is often advanced as an additional reason for sex segregation in contact sports. But, "[a]s one proponent for the integration of contact sports puts it: 'If we are worried about girls' breasts and internal organs, then give them chest and belly protectors. We haven't spared our male football players any expense in that department.'"²²² Male athletes, no less than female, may get hurt playing certain sports. In the team selection process girls not sturdy enough to play successfully will be weeded out as are weak boys. Girls must be able to decide for themselves whether or not the rewards of playing certain sports are greater than the possibility of injury. Boys of all levels of strength and ability play all types of intra-mural sports. This situation may be compared to *Weeks v. Southern Bell Telephone & Telegraph Co.*,²²³ where the court held that calling a job strenuous would not disallow a woman from making her own decision on whether the effort of the job was worth the pay and other advantages. Women can no longer be "protected" by rules and regulations that for the most part discriminate against them.

If separate teams are justified to prevent de facto exclusion of women from competitive sports, the next question is whether female athletes should nonetheless be allowed to try out for the men's team in this separate-but-equal situation. People dedicated to equalizing opportunities for women and knowledgeable in the area of athletics disagree to such an extent on this question that judgment should be left to individual schools. Brenda Feigen Fasteau would not allow women to "compete up" because of the

²¹⁸ See text accompanying notes 43-48, 75-76 *supra*.

²¹⁹ *Id.*

²²⁰ See text accompanying notes 206-07 *supra*.

²²¹ See text accompanying notes 32-41 *supra*.

²²² Fasteau, *supra* note 149, at 103.

²²³ 408 F.2d 228 (5th Cir. 1969).

potential unfairness to men who could possibly make the women's team but not the men's.²²⁴ "Even more importantly, it cheats the women's team which would lose its best athletes to the male squads, thus setting women's sports back even farther."²²⁵ If an equally well-equipped girls' team is available, the question of "competing up" should be left to recipients. This is the approach apparently taken in the regulations.

Even if a difference in competitive athletic opportunities passes muster under sections 86.41(a) and (b),²²⁶ it can still be challenged under the multifactor test of section 86.41(c).²²⁷ For example, if a school sponsors all-male football, basketball, boxing, and wrestling teams but no teams at all for girls, no attack can be made under sections 86.41(a) and (b).²²⁸ This arrangement, however, is clearly subject to challenge under the "equal athletic opportunity" requirement of section 86.41(c).²²⁹ It is difficult to predict how challenges to less blatant discrimination will fare when the Director considers the ten factors listed in subsection (c).

IV. CONCLUSION

Title IX's general prohibition of sex discrimination in education should be construed broadly, and the limited living facilities exception narrowly, in order to effect the remedial purpose of the statute. There is no justification for most sex-based discrimination in education. The living facilities exception should be limited to living quarters, restrooms, locker facilities, and other areas where disrobing takes place. The only justification for separation of the sexes other than privacy is to assure access to a program or activity for both male and female students. This justification will operate only in the area of competitive athletics.

The HEW regulations adhere to this analysis fairly closely. Their breadth fits in well with judicial construction of Titles VI and VII of the Civil Rights Act of 1964. In controversial areas such as athletics, however, the Department has attempted a middle course. The result is ambiguous requirements, which will

²²⁴ Fasteau, *supra* note 149 at 103.

²²⁵ *Id.*

²²⁶ 40 Fed. Reg. 24142-43, §§ 86.41(a), (b) (1975).

²²⁷ *Id.* § 86.41(c).

²²⁸ *Id.* §§ 86.41(a), (b).

²²⁹ *Id.* § 86.41(c).

make enforcement difficult. Nevertheless, HEW's conscientious oversight of educational institutions receiving federal financial assistance should have a great influence in removing sex discrimination from the educational system.

PIERCE v. COOK & CO.: CHANGE IN STATE
LAW AS A GROUND FOR RELIEF FROM
A FEDERAL JUDGMENT

A supervening change in controlling law generally is not held to justify relief from a final judgment under rule 60(b)¹ of the Federal Rules of Civil Procedure. The Court of Appeals for the Tenth Circuit relied on clause (6) of rule 60(b), however, to grant relief on this ground in *Pierce v. Cook & Co.*,² in which parties to a common catastrophe litigated to different conclusions in federal and state courts due to earlier resolution in the federal courts and a subsequent change of the controlling precedent in the state courts.

Pierce involved a vehicular accident which occurred on January 11, 1968, in Oklahoma. Ted Pierce was killed and passengers in his car were injured in a collision with an independent contractor who was transporting wheat for defendant-appellee Cook. Pierce's widow, Claudiatte Pierce, and Pierce's passengers, Davis and Ellenwood, brought suit against Cook in an Oklahoma state court. On Cook's motion, each suit was removed to federal court on grounds of diversity of citizenship. The Davis suit was dismissed on plaintiff's motion and refiled in state court by co-guardians of Davis, a minor. Because the guardianship destroyed diversity, it precluded removal to federal court. Claudiatte Pierce and Ellenwood were unsuccessful on the merits

¹ FED. R. CIV. P. 60(b) now provides in part:

Mistakes; Inadvertence; Excusable Neglect; Newly Discovered Evidence; Fraud, etc. On motion and upon such terms as are just, the court may relieve a party or his legal representative from a final judgment, order, or proceeding for the following reasons: (1) mistake, inadvertence, surprise, or excusable neglect; (2) newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial under Rule 59(b); (3) fraud (whether heretofore denominated intrinsic or extrinsic), misrepresentation, or other misconduct of an adverse party; (4) the judgment is void; (5) the judgment has been satisfied, released, or discharged, or a prior judgment upon which it is based has been reversed or otherwise vacated, or it is no longer equitable that the judgment should have prospective application; or (6) any other reason justifying relief from the operation of the judgment. The motion shall be made within a reasonable time, and for reasons (1), (2) and (3) not more than one year after the judgment, order, or proceeding was entered or taken. A motion under this subdivision (b) does not affect the finality of a judgment or suspend its operation.

² 518 F.2d 720 (10th Cir. 1975), *cert. denied*, 44 U.S.L.W. 3412 (U.S. Jan. 19, 1976).

in the federal district court, which awarded Cook summary judgment on the basis of Oklahoma precedent established in *Marion Machine, Foundry & Supply Co. v. Duncan*,³ the Tenth Circuit affirmed.⁴ The decision of the circuit court became final in January, 1971. The state trial court in the Davis suit also granted Cook summary judgment, finding *Marion Machine* controlling. On appeal the Oklahoma Supreme Court specifically overruled *Marion Machine* and remanded the suit for jury trial.⁵ The case was then settled favorably to plaintiff Davis.

The Oklahoma Supreme Court judgment became final in May, 1974. In November, 1974, Claudiatte Pierce and Ellenwood filed a rule 60(b) motion with the Tenth Circuit, seeking relief from the judgment of that court as a matter of law. The Tenth Circuit, sitting en banc, held that the movants were entitled to relief from the circuit court's judgment under rule 60(b)(6) because the federal courts in which they were forced to litigate treated them substantially differently than the state supreme court treated another person injured in the same accident, contrary to the command of *Erie Railroad v. Tompkins*⁶ and the interest of justice. The case was remanded to the district court which was directed, upon movants' filing of the motion below, to consider the rule 60(b)(6) motion as one for relief from the trial court's judgment in light of the supervening Oklahoma decision and the opinion of the Tenth Circuit.

Thus *Pierce* presents the question whether rule 60(b)(6) relief from a federal judgment in a diversity case is required either by the *Erie* doctrine or by the need to correct the inequity of divergent results on the same or similar facts, when the state law relied upon by the federal court is subsequently altered.

I. RELIEF UNDER RULE 60(b)(6) GENERALLY

When relief may properly be granted under clause (6) of rule 60(b) depends on the function of the rule as a whole and on the relationship of clause (6) to the preceding five clauses. Rule 60(b) in its present form⁷ embodies a balancing of the conflicting

³ 187 Okla. 160, 101 P.2d 813 (1940).

⁴ *Pierce v. Cook & Co.* 437 F.2d 1119 (10th Cir. 1970).

⁵ *Hudgens v. Cook Industries, Inc.*, 521 P.2d 813 (Okla. 1973).

⁶ 304 U.S. 64 (1938). Compare text accompanying notes 59-66 *infra* with text accompanying notes 93-121 *infra*.

⁷ Note 1 *supra*. The substance of rule 60(b) in its present form is the product of the 1946 amendments. In 1948, the rule was insignificantly amended by the substitution of its present statutory reference, "Title 28 U.S.C. § 1655," for its former citation, "Section 57 of the Judicial Code, U.S.C., Title 28, § 118." See J. MOORE, FEDERAL PRACTICE RULES PAMPHLET pl. 1, at 1071 (1975) [hereinafter cited as RULES PAMPHLET].

values of finality of judgments and provision of relief from judgments when justice so requires.⁸ Original rule 60(b) established a six-month limit on the commencement of proceedings for seeking relief from final judgments.⁹ Although the rule effectively lengthened the period of time during which a court had control over its judgments, the grounds for relief were not expanded beyond those previously existing at common law.¹⁰ The courts soon devised ways to evade the six-month time limitation imposed by rule 60(b). Rule 6(b), allowing courts to extend time limits stipulated by the rules, was applied by the courts to rule 60(b); the "inherent power" of courts over their judgments was invoked when the courts wished to grant relief unavailable under the rule; and the ancillary remedies existing prior to the enactment of the Federal Rules were read into rule 60(b).¹¹

In the 1946 amendments, the Advisory Committee established "reasonable time" limits, not to exceed one year, for motions under clauses (1)-(3) while motions under clauses (4)-(6) were made subject only to a "reasonable time" requirement.¹² Rule 6(b) was amended to prohibit the extension of the maximum time periods prescribed by rule 60(b).¹³ Relief previously available by ancillary remedies was incorporated into rule 60(b).¹⁴ Under the 1946 amendments, relief was to be obtained exclusively by motion under one of the six clauses of rule 60(b) or by an independent action to enjoin enforcement of the judgment.¹⁵ The sixth clause, upon which the Tenth Circuit relied in *Pierce*, is a residual clause which was inserted to provide relief in unforeseen circumstances.¹⁶

According to the prevailing interpretation of rule 60(b)(6),

⁸ *Bankers Mortgage Co. v. United States*, 423 F.2d 73, 77 (5th Cir.), cert. denied, 399 U.S. 927 (1970); 7 J. MOORE, *FEDERAL PRACTICE* ¶ 60.18[2], at 203 (2d ed. 1975); Comment, *Rule 60(b): Survey and Proposal for General Reform*, 60 CAL. L. REV. 531, 533 (1972).

⁹ 7 J. MOORE, *supra* note 8, ¶ 60.09, at 10-10.1.

¹⁰ Comment, *Civil Procedure—Federal Rules 60(b)(5) & (6)—Applicability to Change of Law Situation*, 44 IOWA L. REV. 574, 574-75 (1959).

¹¹ Note, *Federal Rule 60(b): Relief From Civil Judgments*, 61 YALE L.J. 76, 78 (1952). For a discussion of original rule 60(b), see 7 J. MOORE, *supra* note 8, ¶¶ 60.10-17 at 10.1-94; Comment, *supra* note 8, at 535-37; Comment, *Temporal Aspects of the Finality of Judgments—The Significance of Federal Rule 60(b)*, 17 U. CHI. L. REV. 664, 668-69 (1950).

¹² FED. R. CIV. P. 60(b); see 7 J. MOORE, *supra* note 8, ¶ 60.27[3], at 378.

¹³ See RULES PAMPHLET, *supra* note 7, at 1076.

¹⁴ See 7 J. MOORE, *supra* note 8, ¶ 60.18[8], at 224-25; 58 MICH. L. REV. 793, 794 (1960). The grounds for relief under clauses (1)-(3) were historically equitable, those under clauses (4) & (5) were historically legal, while clause (6) "invokes the pure equity power of the court." Comment, *Equitable Power of a Federal Court to Vacate a Final Judgment for "Any Other Reason Justifying Relief"—Rule 60b(6)*, 33 MO. L. REV. 427, 434-35 (1968).

¹⁵ 7 J. MOORE, *supra* note 8, ¶ 60.18[8], at 225; Comment, *supra* note 8, at 537.

¹⁶ 7 J. MOORE, *supra* note 8, ¶ 60.27[2], at 353-54.

relief cannot be granted under that clause on a ground covered by any of the first five clauses. In *Klapprott v. United States*,¹⁷ the first Supreme Court case construing rule 60(b)(6), Justice Black stated that "the language of the 'other reason' clause, for all reasons except the five particularly specified, vests power in courts adequate to enable them to vacate judgments whenever such action is appropriate to accomplish justice."¹⁸ This view was reaffirmed by the Court a year later in *Ackermann v. United States*,¹⁹ this time over Justice Black's dissent.²⁰ Construing clause (6) and clauses (1)-(5) to be mutually exclusive is consistent with the scheme of time limits in the whole rule and the wording of clause (6): If relief could be granted on the same facts under either clauses (1)-(3) or clause (6), the purpose of the one year time limitation on clauses (1)-(3) would be undermined, and the word "other" in clause (6) would be meaningless.²¹

¹⁷ 335 U.S. 601, *modified*, 336 U.S. 942 (1949). The district court entered a denaturalization decree against Klapprott by default. Due to incarceration and illness Klapprott had been unable to attend the denaturalization proceedings or to petition for relief from the decree for more than four years after the issuance of the decree. The district court dismissed Klapprott's subsequent petition to set aside the judgment because of laches, and the court of appeals affirmed. The Supreme Court reversed and remanded with directions to determine the veracity of the allegations contained in the petition to vacate the default judgment.

¹⁸ *Id.* at 614-15.

¹⁹ 340 U.S. 193 (1950). The district court entered judgments cancelling the naturalization certificates of petitioner, his wife, and a relative. Petitioner and his wife failed to appeal because of lack of funds. The relative's decree was subsequently reversed on appeal. Then, more than four years after entry of the judgment against the petitioner, he petitioned the district court to vacate the judgment of denaturalization. The district court denied petitioner's rule 60(b) motion for relief, and the court of appeals affirmed. The Supreme Court upheld the decisions of the lower courts.

²⁰ Repudiating the literal effect of his *Klapprott* opinion, Justice Black argued that the specified grounds for relief in rule 60(b)(1)-(5) were not intended to prevent the granting of similar relief in other situations where justice so requires. *Id.* at 202-03 (Black, J., dissenting). Consistent with Justice Black's dissent, Judge Hand in *United States v. Karahalas*, 205 F.2d 331 (2d Cir. 1953), read rule 60(b)(6) "to provide for situations of extreme hardship, not only those, if there be any, that subsections (1), (2) and (3) do not cover, but those that they do." *Id.* at 333. On rehearing, however, Judge Hand noted the divergence of his interpretation of rule 60(b)(6) from the majority's reasoning in *Klapprott* and retracted the opinion to that extent. *Id.* at 335.

Not all courts, however, conscientiously adhere to the mutual exclusivity principle. See, e.g., *Tozer v. Charles A. Krause Milling Co.*, 189 F.2d 242 (3d Cir. 1951) (relief granted on motion under 60(b)(1) and (6) without rejecting either clause); *Nelms v. Baltimore & Ohio R.R.*, 11 F.R.D. 441 (N.D. Ohio 1951) (relief granted under 60(b) without identifying a specific clause).

²¹ *Klapprott v. United States*, 335 U.S. 601, 626 (Reed, & Jackson, JJ., & Vinson, C.J., dissenting), *modified*, 336 U.S. 942 (1949); *Gambocz v. Ellmyer*, 438 F.2d 915, 917 (3d Cir.), *cert. denied*, 403 U.S. 919 (1971); *Federal Deposit Ins. Corp. v. Alker*, 30 F.R.D. 527, 532 (E.D. Pa. 1962), *aff'd*, 316 F.2d 236 (3d Cir.), *cert. denied*, 375 U.S. 880 (1963); 7 J. MOORE, *supra* note 8, ¶ 60.27[1], at 343-44.

The language of rule 60(b)(6) requires not only that the reason for relief fall outside of the preceding five clauses, but also that the reason be one "justifying relief." Justice Black's opinion in *Klapprott* contains broad language to the effect that rule 60(b)(6) should be applied to afford relief "whenever such action is appropriate to accomplish justice."²² Thus, courts commonly hold that rule 60(b), and specifically clause (6), should be interpreted liberally to do justice in particular cases.²³ But Justice Black's opinion also observed that the facts before the Court presented an "extraordinary situation."²⁴ The Court later emphasized this aspect of the *Klapprott* case in denying rule 60(b)(6) relief in *Ackermann*, making an "extraordinary situation" a requirement for rule 60(b)(6) relief.²⁵

In addition, several general principles must be considered in determining whether a party should be relieved of a judgment under rule 60(b)(6) or any of the preceding clauses. Consideration must be given to the principle of finality of judgments;²⁶ rule 60(b) cannot be used as a substitute for appeal;²⁷ justification must be shown for failure to resort to other remedies;²⁸ a rule 60(b) motion must be made within a reasonable time;²⁹ and consideration must be given to any prejudice that might result to the other party,³⁰ to any intervening equities that would make it unjust to grant relief,³¹ and to any other factors affecting the equities of the case.³²

²² 335 U.S. at 615.

²³ E.g., *Radack v. Norwegian America Line Agency, Inc.*, 318 F.2d 538, 542 (2d Cir. 1963); *Erick Rios Bridoux v. Eastern Air Lines, Inc.*, 214 F.2d 207, 210 (D.C. Cir.), cert. denied, 348 U.S. 821 (1954); *Tozer v. Charles A. Krause Milling Co.*, 189 F.2d 242, 245 (3d Cir. 1951); 7 J. MOORE, *supra* note 8, ¶ 60.27[1], at 342.

²⁴ 335 U.S. at 613.

²⁵ See, e.g., *Wagner v. United States*, 316 F.2d 871, 872 (2d Cir. 1963); *Collins v. City of Wichita*, 254 F.2d 837, 839 (10th Cir. 1958); *Loucke v. United States*, 21 F.R.D. 305, 308 (S.D.N.Y. 1957). See generally *Elgin Nat'l Watch Co. v. Barrett*, 213 F.2d 776 (5th Cir. 1954).

²⁶ See, e.g., *Ackermann v. United States*, 340 U.S. 193, 198 (1950); *Collins v. City of Wichita*, 254 F.2d 837, 839 (10th Cir. 1958).

²⁷ See *Ackermann v. United States*, 340 U.S. 193, 198 (1950); *Rinieri v. News Syndicate Co.*, 385 F.2d 818, 822 (2d Cir. 1967).

²⁸ 7 J. MOORE, *supra* note 8, ¶ 60.27[1], at 348-49, ¶ 60.28[2], at 403; Wham, *Federal District Court Rule 60(b): A Humane Rule Gone Wrong*, 49 A.B.A.J. 566 (1963).

²⁹ 7 J. MOORE, *supra* note 8, ¶ 60.27[3], at 378.

³⁰ E.g., *Pierre v. Bernuth Lembcke Co.*, 20 F.R.D. 116, 117 (S.D.N.Y. 1956); Comment, *supra* note 8, at 565.

³¹ E.g., *Albion-Idaho Land Co. v. Adams*, 58 F. Supp. 579, 581-82 (D. Idaho 1945).

³² 7 J. MOORE, *supra* note 8, ¶ 60.27[1], at 351.

II. OPERATION OF THE MUTUAL EXCLUSIVITY REQUIREMENT IN THE CHANGE OF LAW CONTEXT

A. *Implications of the Requirement*

Because the reasons for relief under rule 60(b)(6) must be exclusive of those under clauses (1)-(5), a supervening change of law must be shown to be outside of the scope of any of the first five clauses if it is to serve as a ground for relief under clause (6). Although a grant of relief under any of the six clauses would bring the same result, the clause relied upon must be determined. First, strict adherence to the doctrine of mutual exclusivity could result in a denial of relief when the rule 60(b) motion is filed after one year from the entry of the judgment, as it was in *Pierce*, if the change of law ground were found to be subsumed under one of the first three clauses. Little practical difference would result, however, if the change of law ground were covered by clauses (4) or (5) rather than clause (6), because motions under these three provisions are subject to the same flexible limit of "reasonable time."³³ Second, alleged grounds for relief not enumerated in the first five clauses are subject to the "extraordinary situation" requirement established for rule 60(b)(6) by the Supreme Court.³⁴

Arguments have been made that a judgment may be set aside on the ground of a supervening change in controlling law under clauses (1) and (5) of rule 60(b). As demonstrated below, these arguments fail to establish that rule 60(b)(6) relief in a change of law situation is precluded by the mutual exclusivity principle.

B. *Relief Under Rule 60(b)(1)*

Professor Moore asserts that relief from judgments because of a post-judgment change in the applicable law may be available under 60(b)(1) in a limited class of cases.³⁵ Moore's position is based upon a construction of the word "mistake" in 60(b)(1) that includes a substantive error of law by the court.³⁶ Original rule 60(b) provided for relief when the moving party had made an error of law but not when the error was made by the court. Relief from judicial error was still available by the common law remedy of the bill of review for error apparent upon the record,

³³ *Id.* ¶ 60.27[1], at 346.

³⁴ See text accompanying notes 22-25 *supra*. See also Wham, *supra* note 28, at 567.

³⁵ 7 J. MOORE, *supra* note 8, ¶ 60.22[3], at 258-67.

³⁶ *Id.* ¶ 60.22[3], at 260.

left standing by the saving clause of original rule 60(b).³⁷ Moore asserts that although the bill of review did not afford relief in a change of law situation because the error was not apparent upon the record, new rule 60(b)(1) should not be limited by the practice under the bill of review because the word "mistake" in the new rule is broader than the term "error of law apparent upon the record."³⁸ In deference to the principle of finality and the general rule that 60(b) is not a substitute for appeal, Moore suggests that the definition of "reasonable time," which has an upper bound of one year for 60(b)(1), should be further limited so as never to exceed the time allowed for appeal from the judgment.³⁹ Consequently, a moving party could not circumvent the time limits for appeal by bringing a rule 60(b) motion after the time allowed for appeal had expired. The advantage of affording relief under rule 60(b)(1) for judicial error would be the avoidance of the inconvenience and expense of an appeal when the trial court is prepared to correct its own error.⁴⁰

The question arises whether, in circuits subscribing to Moore's interpretation of rule 60(b)(1), judgments can be set aside under rule 60(b)(6) on the basis of a supervening change in controlling law without violence to the mutual exclusivity principle. To allow relief after the challenged judgment has been affirmed on appeal, as in the *Pierce* case, would transgress neither the requirement that rule 60(b) not serve as a substitute for appeal nor the principle of mutual exclusivity. The first requirement is satisfied because relief is granted only after the moving party has diligently, though unsuccessfully, pursued his remedy of appeal.⁴¹ The doctrine of mutual exclusivity is re-

³⁷ *Id.*

³⁸ *Id.* 261.

³⁹ *Id.* Cases in which rule 60(b) relief was granted under the conditions proposed by Professor Moore include *Tarkington v. United States Lines Co.*, 222 F.2d 358 (2d Cir. 1955) and *Oliver v. Monsanto Co.*, 56 F.R.D. 370 (S.D. Tex. 1972), *aff'd*, 487 F.2d 514 (5th Cir. 1973).

⁴⁰ 7 J. MOORE, *supra* note 8, ¶ 60.22[3], at 260.

⁴¹ To require the moving party to appeal the judgment in order to qualify for rule 60(b)(6) relief, however, would not be beneficial. If the trial judge has correctly applied the law that is soon to be changed but still is controlling during the time for appeal, bringing a futile appeal will accomplish little. See *Polites v. United States*, 364 U.S. 426, 437-38 (1960) (Brennan, J., dissenting). But see *id.* at 431-33 (majority opinion suggesting that such an appeal must be taken).

Even if an appeal were not required, other principles of law may limit the amount of time available to a petitioner who has justifiably chosen not to appeal. For example, how long would such a case remain *sub judice*? See text accompanying notes 67-90 *infra*. In the *Pierce* case petitioners did bring an appeal; a full discussion of the problems presented by the failure to appeal is beyond the scope of this Comment.

spected because the supervening change in law upon which 60(b)(6) relief is based occurred after an appeal was taken and thus was not in existence during the time prescribed by Moore for relief under rule 60(b)(1). In addition, unlike the conditions underlying the traditional bases of relief under clauses (1)-(3), which are discoverable and hence remediable within one year after entry of a judgment, at least in theory, a change of law leading to the motion for relief under clause (6) may not even materialize until the time limit on the first three clauses has expired. Therefore, it is fallacious to presume that relief was available under rule 60(b)(1). Thus a court that construes rule 60(b)(1) to provide relief in a change of law situation before the time for appeal has run is not necessarily barred by the doctrine of mutual exclusivity from granting relief under rule 60(b)(6) in response to a supervening change of law after the judgment has been appealed.

C. *Relief Under Rule 60(b)(5)*

The moving parties in *Pierce* urged rule 60(b)(5) as an alternative basis for relief but the majority ignored this argument in its opinion.⁴² Although the language of the two component clauses of rule 60(b)(5) may appear at first reading to allow relief in a change of law situation, such relief is not available on that ground except in limited situations.

The first clause authorizes relief when "a prior judgment upon which the challenged judgment is based has been reversed or otherwise vacated"⁴³ A judgment must have been explicitly and directly based on a prior reversed judgment to be set aside under this clause. A change in controlling law after entry of the judgment does not satisfy this requirement.⁴⁴ In reaching this result, the First Circuit in *Lubben v. Selective Service System*⁴⁵

⁴² Chief Judge Lewis, dissenting in *Pierce*, criticized the court's reliance on rule 60(b)(6) when the moving parties sought relief only under rule 60(b)(5). 518 F.2d at 725 (Lewis, C.J., dissenting). The majority, in determining whether the movants presented facts justifying relief under any of the clauses of rule 60(b) rather than denying relief because the movants used the wrong nomenclature, followed the better course. See 7 J. MOORE, *supra* note 8, ¶ 60.18[8], at 216.1 (nomenclature is unimportant); e.g., *United States v. Jacobs*, 298 F.2d 469, 472-73 (4th Cir. 1961) (60(b) relief granted even without a rule 60(b) motion); *In re Cremidas' Estate*, 14 F.R.D. 15 (D. Alas. 1953) (60(b) relief granted on petition for a writ of *coram nobis*).

⁴³ FED. R. CIV. P. 60(b)(5).

⁴⁴ *Berryhill v. United States*, 199 F.2d 217, 219 (6th Cir. 1952); *Loucke v. United States*, 21 F.R.D. 305, 307-08 (S.D.N.Y. 1957); Comment, *supra* note 10, at 575-77; Note, *Federal Rule 60(b): Finality of Civil Judgments v. Self-Correction by District Court of Judicial Error of Law*, 43 NOTRE DAME LAW. 98, 104 (1967).

⁴⁵ 453 F.2d 645 (1st Cir. 1972).

described the requisite relationship between the prior and subsequent judgments:

For a decision to be "based on" a prior judgment within the meaning of Rule 60(b)(5), the prior judgment must be a necessary element of the decision, giving rise, for example, to the cause of action or a successful defense. . . . It is not sufficient that the prior judgment provides only precedent for the decision.

....

. . . [A] change in applicable law does not provide sufficient basis for relief under Rule 60(b)(5).⁴⁶

The second relevant clause of 60(b)(5) allows relief from a judgment when "it is no longer equitable that the judgment should have prospective application" ⁴⁷ This provision is used primarily for relief from permanent injunctions;⁴⁸ it encompasses cases in which a change of law makes the continuance of an injunction inequitable.⁴⁹ Although this provision is not limited to equitable decrees, a judgment may not be brought within its purview unless it has a prospective application.⁵⁰

Because the *Pierce* case involved a judgment neither directly based on a previously reversed judgment nor intended for prospective application, relief under rule 60(b)(5) would not have been proper. Thus relief under rule 60(b)(6) did not violate the principle of mutual exclusivity.

III. CHANGE IN APPLICABLE LAW AS A REASON "JUSTIFYING RELIEF" UNDER RULE 60(b)(6)

A. *The Pierce Rationale*

Even when the mutual exclusivity test has been satisfied, rule 60(b)(6) relief must be justified under equitable principles,⁵¹ including a showing of an "extraordinary situation."⁵² The court

⁴⁶ *Id.* at 650 (citations omitted).

⁴⁷ FED. R. CIV. P. 60(b)(5).

⁴⁸ Comment, *supra* note 10, at 576; see *Elgin Nat'l Watch Co. v. Barrett*, 213 F.2d 776, 780 (5th Cir. 1954).

⁴⁹ 7 J. MOORE, *supra* note 8, ¶ 60.26[4], at 335-36 (especially apt when a federal injunction is based on state law that has changed).

⁵⁰ *Id.* 337; see *Polities v. United States*, 364 U.S. 426, 438 (1960) (Brennan, J., dissenting, argued that relief was appropriate under rule 60(b)(5) because the challenged judgment, a denaturalization decree, determined status affecting future conduct); Note, *supra* note 44, at 105.

⁵¹ See text accompanying notes 26-32 *supra*.

⁵² See text accompanying notes 24 & 25 *supra*.

in *Pierce* held that the supervening change in state law justified relief under rule 60(b)(6) because (1) otherwise the inconsistency of results in the state and federal courts on the same facts in a diversity case would violate the "outcome determination principle mandated by *Erie v. Tompkins*,"⁵³ and (2) different treatment by the state and federal courts of persons injured in the same accident would be unjust.⁵⁴

Pierce represents a significant departure from prior interpretations of rule 60(b)(6) in holding that a change in controlling law is cause for setting aside a final judgment. Relief in a change of law situation has been denied even when the applicant diligently pursued his remedy of appeal⁵⁵ or lacked the financial resources to appeal.⁵⁶ Despite considerable equities on the side of the moving party, the interest in finality of judgments has prevailed.⁵⁷ *Pierce* is all the more remarkable because, rather than treat the motion before the court as a request for leave to file a motion for relief with the district court, whose ruling on the motion would be subject to review only for an abuse of discretion, the court of appeals granted relief from its judgment as a matter of law.⁵⁸ The *Pierce* rationale, however, provides shaky support at best for its exceptional holding.

⁵³ *Pierce v. Cook & Co.* 518 F.2d 720, 723 (10th Cir. 1975) (citing *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938)). Compare text accompanying notes 59-66 *infra* with text accompanying notes 93-121 *infra*.

⁵⁴ 518 F.2d at 723. See text accompanying notes 94-112 *infra*.

⁵⁵ *Collins v. City of Wichita*, 254 F.2d 837 (10th Cir. 1958).

⁵⁶ *Loucke v. United States*, 21 F.R.D. 305 (S.D.N.Y. 1957); cf. *Ackermann v. United States*, 340 U.S. 193 (1950).

⁵⁷ *Loucke v. United States*, 21 F.R.D. 305, 310 (S.D.N.Y. 1957) ("situation with a measure of obvious human appeal").

⁵⁸ 518 F.2d at 722 (majority opinion), 725 (Lewis, C.J., dissenting), 726 (Seth, J., dissenting). It is highly unusual for a circuit court to adjudicate the merits of a rule 60(b) motion in the first instance. A rule 60(b) motion is addressed to the sound discretion of the district court. *E.g.*, *Caribou Four Corners, Inc. v. Truck Ins. Exch.*, 443 F.2d 796, 799 (10th Cir. 1971); *United States v. Jacobs*, 298 F.2d 469, 473 (4th Cir. 1961). A question of law arises when the issue is whether the rule 60(b) motion was made within the time prescribed by the rule such that the district court had the power to grant relief, or when relief turns on such questions as the validity of a judgment; but when the decision to grant relief depends on a discretionary review of the facts of a particular case, the question is one for the district court. 7 J. MOORE, *supra* note 8, ¶ 60.30[1], at 418-19 & n.13.

After the challenged judgment has been affirmed by a court of appeals, however, the district court cannot disturb the judgment without leave of the appellate court. *Butcher & Sherrerd v. Welsh*, 206 F.2d 259, 262 (3d Cir. 1953), *cert. denied*, 346 U.S. 925 (1954). Because the rule 60(b) motion in *Pierce* was filed with the court of appeals, and because the grant or denial of relief depended on an appraisal of the facts, the court of appeals should have treated the motion as a petition for leave to file a motion with the district court. *Tribble v. Bruin*, 279 F.2d 424 (4th Cir. 1960); see *United States v. Jacobs*,

B. *Reliance on Erie Railroad v. Tompkins*

1. Application of the Basic Doctrine

The decision in *Erie Railroad v. Tompkins*⁵⁹ was rendered to guarantee that any case in federal court only because of diversity of citizenship would be decided according to the same substantive law by which it would have been decided had it been brought in state court. If the *Pierce* court held that *Erie* required rule 60(b)(6) relief from judgment in the change of law situation before the court,⁶⁰ such relief would be called for whenever a state court changed state law that had been applied by a federal court in a diversity case and was necessary to its decision. It is unlikely, however, that *Erie* requires retroactive application of state law to federal judgments that have been final for as long as the judgment in *Pierce*; and the availability of alternate remedies during the period in which *Erie* requires the retroactive application of state law⁶¹ makes relief under rule 60(b)(6) inappropriate.

For *Erie* purposes, the *Pierce* case is indistinguishable from the more usual circumstances of an unrelated accident case in which analogous but unconnected suits are brought in state and federal courts, the federal case is resolved first, and the state supreme court alters the law applied by the federal court in the course of adjudicating the state case. *Erie* itself did not involve a common catastrophe; nor was it rendered only to ensure that

298 F.2d 469 (4th Cir. 1961). The cases cited by the majority in *Pierce*, 518 F.2d at 722, discuss whether a district court must obtain leave of an appellate court before entertaining a rule 60(b) motion; they do not support the court's action in hearing the merits of the motion in the first instance.

⁵⁹ 304 U.S. 64 (1938).

⁶⁰ The court said: "The outcome determination principle mandated by *Erie v. Tompkins* has been violated." 518 F.2d at 723.

Whether *Erie* requires the retroactive application of a supervening change in state law in diversity cases is a separate question from whether a federal court must grant rule 60(b) relief in circumstances in which a state court would allow comparable relief from its own judgment. Rule 60(b) is a valid rule of procedure under the Rule-Making Act, 28 U.S.C. § 2071 (1970); granting relief from a federal judgment is determined by the provisions of the rule, not by state policies concerning relief from state judgments. 7 J. MOORE, *supra* note 8, ¶ 60.18[8], at 218; 6A *id.* ¶ 60.04[3], at 4049-51; *cf.* *Hanna v. Plumer*, 380 U.S. 460 (1965). Thus the issue in *Pierce* was not whether the state court would grant relief from its final judgment on the basis of a supervening change in state law, but whether relief was required on the facts as a matter of federal law. Relief under rule 60(b), granted to ensure that the currently controlling state substantive law will be applied, might result ironically in retroactive application of state law in which the state court itself would not engage. This "procedural" conflict is presumably permissible under *Hanna*.

⁶¹ See text accompanying notes 68 & 69 *infra*.

state substantive law would be applied to suits arising from common transactions being litigated simultaneously in state and federal courts. The *Pierce* holding is unsupported to the extent that its finding of an "extraordinary situation" is based on a view that *Erie* requires relief under rule 60(b)(6) only when a federal-state divergence emerges from a common catastrophe.⁶² If the majority in *Pierce* meant not that relief was compelled by *Erie*, but only that the underlying policy of *Erie* of promoting uniform administration of the laws⁶³ moved the court to grant relief, then *Pierce* would not be as far-reaching.⁶⁴

The alternative posed by Judge Barrett in his concurring opinion in *Pierce* also fails to comport with *Erie*. Judge Barrett suggests that a change in state law should not be available as a ground for relief to a party who selected the federal forum voluntarily but only to a party forced to litigate in the federal courts.⁶⁵ This argument is faulty if based on *Erie* and not simply on equitable considerations.⁶⁶ The logical implication of *Erie* is that when state law is controlling, the party selecting the federal forum has the same right to correction of a retrospectively "erroneous" application of state law as the party who is in federal court "involuntarily." *Erie* determined that the decision whether to apply state or federal law is a matter of judicial power, not judicial discretion guided by a sense of fairness or by who brought suit in which court.

2. Application of the *Sub Judice* Requirement

In any case, *Erie* probably does not require vacation of a federal judgment, erroneous in retrospect because of a supervening change in state law, when the decisional change comes as long after entry of the federal judgment as it did in *Pierce*.⁶⁷

⁶² 518 F.2d at 723.

Chief Judge Lewis, dissenting from the decision in *Pierce*, takes this position:

The factual background of this case is based on a common disaster and . . . I assume that the majority ruling is intended to be limited by this "extraordinary circumstance." But the driving force of the ruling, the desire to obtain consistent results in state and federal cases involving state law, to me, seems equally applicable to identical accidents . . . *Id.* at 725 (Lewis, C.J., dissenting).

Judge Seth, also dissenting in *Pierce*, expresses the same view: "The argument advanced by the majority is equally applicable to any diversity case, and the fortuitous circumstance of one accident makes no legal difference whatever . . ." *Id.* at 726 (Seth, J., dissenting).

⁶³ 304 U.S. at 74-75.

⁶⁴ See text accompanying notes 93-121 *infra*.

⁶⁵ 518 F.2d at 724-25 (Barrett, J., concurring).

⁶⁶ See text accompanying notes 93-121 *infra*.

⁶⁷ The federal judgment became final in January, 1971, and the supervening state

Under the Supreme Court ruling in *Vandenbark v. Owens-Illinois Glass Co.*,⁶⁸ federal courts must apply any recent changes in applicable state law "until such time as a case is no longer *sub judice*."⁶⁹ In *Vandenbark*, the Supreme Court reviewed a decision of the Court of Appeals for the Sixth Circuit⁷⁰ not to reverse the district court's judgment in a diversity case after the state court decisions on which the district court relied were overruled by the state supreme court during the appeal. In reversing the decision of the Sixth Circuit the Court held:

Until such time as a case is no longer *sub judice*, the duty rests upon federal courts to apply state law under the Rules of Decision statute in accordance with the then controlling decision of the highest state court. Any other conclusion would but perpetuate the confusion and injustices arising from inconsistent federal and state interpretations of state law.⁷¹

After *Vandenbark* it appeared that a case was no longer *sub judice* once the judgment of a court of appeals had become final. Four years later, however, in *Huddleston v. Dwyer*,⁷² the Supreme Court made clear that recent pronouncements by a state supreme court must be applied to federal decisions even after entry of the judgment of a court of appeals. Petitioners in *Huddleston* filed a timely petition for rehearing with the Tenth Circuit after that court affirmed the judgment of the district court.⁷³ The petition was denied on September 1, 1943. On December 17, 1943, petitioners moved for leave by the circuit court to file a second petition for rehearing, because of a decision of the Supreme Court of Oklahoma⁷⁴ on October 19, 1943, overruling an earlier decision that had been followed by the court of appeals in affirming the judgment of the district court. Petitioners' motion was denied. On certiorari, the Supreme Court vacated the judgment of the Tenth Circuit and remanded the case for reconsideration under the recent rulings of the Supreme Court of Oklahoma. The Court reaffirmed *Vandenbark*, quoting

judgment became final in May, 1974. The rule 60(b) motion was filed in November, 1974. 518 F.2d at 722.

⁶⁸ 311 U.S. 538 (1941).

⁶⁹ *Id.* at 543.

⁷⁰ *Vandenbark v. Owens-Illinois Glass Co.*, 110 F.2d 310 (6th Cir. 1940).

⁷¹ 311 U.S. at 543 (footnote omitted).

⁷² 322 U.S. 232 (1944).

⁷³ *Huddleston v. Dwyer*, 137 F.2d 383 (10th Cir. 1943), *rev'd*, 322 U.S. 232 (1944).

⁷⁴ *Wilson v. City of Hollis*, 193 Okla. 241, 142 P.2d 633 (1943).

the requirement that the federal courts apply recent decisional law as long as the case remains *sub judice*.⁷⁵

The Court of Appeals for the Second Circuit, interpreting *Huddleston* in *Braniff Airways, Inc. v. Curtiss-Wright Corp.*,⁷⁶ believed the Supreme Court to have "indicated that so long as the case was '*sub judice*' the court of appeals should have entertained the petition for rehearing based on a change in state law; [the Supreme Court] did not indicate, however, precisely what the bounds of the term '*sub judice*' might be."⁷⁷ In *Braniff* a change in controlling state law occurred after entry of the judgment of the court of appeals. After the time for petitioning for rehearing by the court of appeals elapsed, petitioners filed a petition for certiorari; while that petition was still pending, they filed a motion with the court of appeals for modification of the judgment or for extension of the time to petition for rehearing. The court of appeals held that it had power under rules 26(b) and 40 of the Federal Rules of Appellate Procedure to extend the time to petition for rehearing and that it could modify an erroneous decision after the time for rehearing had expired. In addition, the court believed that *Huddleston* required it to grant the petition for rehearing and to consider the effect of the recent state ruling.⁷⁸

Huddleston and *Braniff* read together do not necessarily extend indefinitely the period during which a case is *sub judice*. In *Huddleston*, the change in state law came prior to expiration of the time allowed for petitioning for certiorari,⁷⁹ and the motion for leave to file the second petition for rehearing was filed within the sixty-day period by which the time for petitioning for certiorari could be extended.⁸⁰ In *Braniff*, the motion for extension of the time to petition for rehearing was filed before the petition

⁷⁵ 322 U.S. at 236.

⁷⁶ 424 F.2d 427 (2d Cir.), *cert. denied*, 400 U.S. 829 (1970).

⁷⁷ *Id.* at 429.

⁷⁸ *Id.* at 429-30.

⁷⁹ When *Huddleston* was decided in 1943, the time allowed for petitioning for certiorari was "three months." Act of Feb. 13, 1925, ch. 229, § 8(a), 43 Stat. 940, *as amended*, 28 U.S.C. § 2101 (1970). Because the timely petition for rehearing filed by petitioners in *Huddleston* suspended the finality of the court's judgment, *Department of Banking v. Pink*, 317 U.S. 264, 266 (1942), the announcement of the Oklahoma decision in October was within the period allowed for petitioning for certiorari, which extended three months from the denial of the first petition for rehearing on September 1.

⁸⁰ Act of Feb. 13, 1925, ch. 229, § 8(a), 43 Stat. 940, *as amended*, 28 U.S.C. § 2101 (1970). The motion for leave was filed on December 17 which was within this extended period. The Supreme Court in *Huddleston* heard the case after expiration of the initial three-month period which began on September 1, *see note 79 supra*, and ended before filing of the motion for leave to file a petition for rehearing.

for certiorari was disposed of by the Supreme Court.⁸¹ In both cases, then, review by the Supreme Court was still available short of the rehearing process.

The Supreme Court's practice of granting rehearings from its orders complicates the task of defining the time during which a case is *sub judice*. In *Conner v. Simler*,⁸² a diversity case, the Court granted a rehearing on its prior denial of certiorari and then vacated and remanded the case to the Tenth Circuit to consider the case in light of an Oklahoma Supreme Court decision handed down after the initial denial of certiorari. The Court's lack of explanation makes its action in *Conner* ambiguous, and a remand for consideration "in light of" is not a command to apply the new decision.⁸³ *Conner* at least indicates that denial of certiorari does not terminate irrevocably the responsibility of the federal courts to consider supervening state decisions. But it may not be fruitful even to look to the deadline for petitioning for rehearing on a denial of certiorari as an outer limit for the period during which a case is *sub judice*, because the Court on occasion has disregarded its own rules concerning rehearings.⁸⁴

On the other hand, the Court in *Vandenbark* must have contemplated some end to the period during which changes in state law have to be implemented retroactively by the federal courts. If a case were held to be *sub judice* whenever a motion pointing out supervening changes in state law was filed, the concept "*sub judice*" would become circular. A reasonable line might be drawn when a case is denied certiorari or decided on certiorari⁸⁵ such that Supreme Court review is no longer available except through the rehearing procedure.⁸⁶ The cases themselves suggest that a rule 60(b)(6) motion addressed to the lower federal courts after this point may be inappropriate. *Vandenbark*, *Huddleston*, and *Braniff* had not reached disposition by the Supreme Court; the courts of appeals still had control over the cases and were held to be required by *Erie* to apply the newly interpreted state law. In *Connors*, on the other hand, the relief was requested *after* the denial of certiorari and the petition was directed not to the lower federal courts but to the Supreme Court itself. The Supreme

⁸¹ 424 F.2d at 429.

⁸² 367 U.S. 486 (1961), *vacating and remanding* 282 F.2d 382 (10th Cir. 1960).

⁸³ See *The Supreme Court, 1960 Term*, 75 HARV. L. REV. 40, 96 (1961).

⁸⁴ *Gondeck v. Pan Am. World Airways, Inc.*, 382 U.S. 25 (1965).

⁸⁵ Cf. *Collins v. City of Wichita*, 254 F.2d 837 (10th Cir. 1958).

⁸⁶ See text accompanying notes 79-81 *supra*.

Court's rehearing of the case with the subsequent vacation and remand appears to have been discretionary and the court of appeals was not required to apply but only to consider the new state opinion. If the case had still been *sub judice*, presumably the court of appeals would have been bound to apply the new law under *Erie* as interpreted in *Vandenbark*.⁸⁷

In any event, the surprise and disruption that would result from retroactive application of state law beyond this point may outweigh the interest in exactly parallel application of state law.⁸⁸ In addition, because the state courts themselves might not apply their recent decisions to judgments they entered years before the change of law, discrimination might result between those who choose the federal forum and those who choose to stay in the state system in diversity cases.⁸⁹

Although it is difficult to fix a precise point signifying the termination of the period during which a case is *sub judice*, the period in *Pierce* was beyond the range of reasonableness. In *Pierce*, the rule 60(b) motion was filed almost four years after the judgment of the Tenth Circuit became final.⁹⁰ Moreover, during the limited period following entry of judgment by the court of appeals in which the federal courts arguably are bound to recognize supervening changes in state law, *Huddleston* and *Braniff* indicate that relief is available through a petition for rehearing addressed to the court of appeals. Normally rule 60(b) relief is not available when other remedies exist.⁹¹ Relief under rule 60(b)(6), an extreme remedy,⁹² is especially inappropriate in these circumstances.

C. Role of Equitable Concerns

To say that *Erie* does not require relief under rule 60(b)(6) on the facts of *Pierce* is not to deny that one of the policies underlying *Erie*—preventing inequitable administration of the laws⁹³—may be an adequate justification for allowing relief under rule 60(b)(6) in a change of law situation. Accomplishing justice in particular cases is a major concern of rule 60(b). In fact, remedying the inequity of inconsistent treatment by the

⁸⁷ 311 U.S. at 543. See text accompanying notes 69-71 *supra*.

⁸⁸ See *The Supreme Court, 1960 Term*, *supra* note 83, at 97.

⁸⁹ But see note 60 *supra*.

⁹⁰ 518 F.2d at 722.

⁹¹ 7 J. MOORE, *supra* note 8, ¶ 60.28[2], at 403; see Wharm, *supra* note 28, at 566.

⁹² *Loucke v. United States*, 21 F.R.D. 305, 308 (S.D.N.Y. 1957).

⁹³ 304 U.S. at 74-75.

state and federal courts of parties to the same accident was a second motivating force behind the *Pierce* opinion. The question presented is whether *Pierce* truly is distinguishable on equitable grounds from situations involving unconnected but similar accidents, in which litigants in federal court are treated differently from litigants in state courts or even litigants in the same federal court at a later time, because of a supervening change in controlling law.

In reaching its decision in *Pierce*, the Tenth Circuit referred specifically to the unfairness of inconsistent treatment only briefly, by quoting from *Gondeck v. Pan American World Airways, Inc.*⁹⁴ In that case, petitioner was awarded death benefits by the Department of Labor under the Longshoremen's and Harbor Workers' Compensation Act.⁹⁵ The district court judgment setting aside the award was affirmed by the Fifth Circuit.⁹⁶ The Supreme Court denied certiorari⁹⁷ and the following term denied rehearing.⁹⁸ The Fourth Circuit subsequently upheld an award to the survivors of another employee killed in the same accident.⁹⁹ The Supreme Court then granted rehearing to the survivors of the first employee, granted certiorari, and reversed the judgment of the Fifth Circuit. Speaking of its deviation from United States Supreme Court Rule 58(2) concerning rehearings, the Court said: "[S]ince, of those eligible for compensation from the accident, this petitioner stands alone in not receiving it, 'the interests of justice would make unfair the strict application of our rules.'"¹⁰⁰ Judge Seth, dissenting in *Pierce*, may have been correct in his observation that the Supreme Court in *Gondeck* was simply acting in its supervisory capacity to require two circuits to construe a federal statute consistently.¹⁰¹ Yet the Court's language in *Gondeck* does emphasize the peculiar inequity in the different treatment of parties to the same event, which may have entered into the Court's determination to abandon its own rules and hear the case.¹⁰²

Unfairness exists, however, in any case in which a superven-

⁹⁴ 382 U.S. 25, 27 (1965), quoted in 518 F.2d at 723.

⁹⁵ 33 U.S.C. §§ 901-50 (1970).

⁹⁶ 299 F.2d 74 (5th Cir. 1962), *rev'd*, 382 U.S. 25 (1965).

⁹⁷ 370 U.S. 918 (1962).

⁹⁸ 371 U.S. 856 (1962).

⁹⁹ *Pan Am. World Airways, Inc. v. O'Hearne*, 355 F.2d 70 (4th Cir. 1964), *cert. denied*, 380 U.S. 950 (1965).

¹⁰⁰ 382 U.S. at 27 (quoting *United States v. Ohio Power Co.*, 353 U.S. 98, 99 (1957), quoted in 518 F.2d at 723).

¹⁰¹ 518 F.2d at 726 (Seth, J., dissenting).

¹⁰² See R. STERN & E. GRESSMAN, *SUPREME COURT PRACTICE* 519 (4th ed. 1969).

ing change of controlling law, state or federal, results in the incompatible treatment of persons similarly situated.¹⁰³ In fact, two Justices of the Supreme Court found the equities more compelling in an unrelated accident case, *Weed v. Bilbrey*,¹⁰⁴ than in *Gondeck*. In *Weed*, two men were killed in navigable waters in Florida in unconnected accidents. Weed, a widow of one of the men killed, was unsuccessful in the state courts with her claim that maritime law afforded a cause of action for wrongful death. The second widow, Moragne, litigated to the same conclusion in the federal courts. Weed preceded Moragne to the Supreme Court, but her first petition for certiorari was denied over three dissents.¹⁰⁵ Three weeks later, Moragne raised the same claim in her petition for certiorari. Weed's petition for rehearing, asking that her claim be heard with Moragne's, was denied.¹⁰⁶ Subsequently, certiorari was granted in the *Moragne* case.¹⁰⁷ Weed was denied leave to file a second petition for rehearing.¹⁰⁸ Thereafter, Moragne prevailed in the Supreme Court.¹⁰⁹ Justice Douglas, joined by Justice Black, dissented from the denial of Weed's third petition for rehearing:

Every plaintiff who loses his claim cannot reinstate his action when a rule of law favorable to him is declared, either by the legislature or the court. But that is not what is attempted here. . . . The facts of this case are even more compelling than those in *Gondeck* Moreover, had Mrs. Weed proceeded through the federal courts, or had she instituted her suit later, she might have arrived in this Court after Mrs. Moragne.¹¹⁰

The majority's decision not to grant a rehearing in *Weed*, despite having granted a rehearing in *Gondeck*, does not necessarily imply that the majority disagreed with Justices Douglas and Black on the issue of fairness. The results in the two cases are reconcilable independently of the equities because Supreme Court review was required in *Gondeck* to resolve a conflict in the circuits¹¹¹ but was unnecessary in *Weed* because the pertinent

¹⁰³ *Id.*

¹⁰⁴ 400 U.S. 982, 984 (1970) (Douglas & Black, JJ., dissenting).

¹⁰⁵ 394 U.S. 1018 (1969) (Douglas, Black & Brennan, JJ., dissenting).

¹⁰⁶ 395 U.S. 971 (1969).

¹⁰⁷ *Moragne v. States Marine Lines, Inc.*, 396 U.S. 900 (1969).

¹⁰⁸ 397 U.S. 930 (1970).

¹⁰⁹ *Moragne v. States Marine Lines, Inc.*, 398 U.S. 375 (1970).

¹¹⁰ 400 U.S. at 984.

¹¹¹ *Pierce v. Cook & Co.*, 518 F.2d 720, 726 (1975) (Seth, J., dissenting); see text accompanying note 101 *supra*.

legal issue was raised in *Moragne*.¹¹² The position of the dissenting Justices in *Weed* suggests that an unrelated accident case may present as strong a case for relief as a related accident case like *Gondeck* or *Pierce*. At least, the subjective perception that denial of relief would result in greater unfairness to the moving party in a related accident case than in an unrelated accident case is not sufficiently persuasive to establish the former as an extraordinary situation as a matter of law.

If the distinction between cases of related and unrelated accidents in terms of fairness to the unsuccessful party is too amorphous to justify an exception to the general practice of not allowing rule 60(b) relief in a change of law situation, perhaps the *Pierce* decision may be justified by the differing degrees of prejudice to the prevailing party occasioned by granting relief in the two types of cases. In the *Pierce* situation, the defendant secured a favorable judgment in the federal courts earlier than in the state courts. His expectations about the finality of the federal judgment may have been less crystalized than those of a prevailing party who had all claims growing out of the same event litigated in a single court. The split litigation in *Pierce* may have given rise to a sense of nonfinality until all adjudication arising from the accident had been consummated. When perceptions of finality are still tentative, setting aside a judgment rendered early in the course of multiple-action litigation on the basis of later determinations may be considered not to encroach severely upon the interest in finality of judgments.

The subjective sense of unfairness to the unsuccessful party in a related accident case and the absence of substantial prejudice to the prevailing party are probably necessary but not sufficient to justify the holding in *Pierce*. In *Ackermann*,¹¹³ for example, the Supreme Court upheld the denial of rule 60(b)(6) relief to the petitioner from a denaturalization decree even though the denaturalization judgment against the petitioner's relative, issued in the same proceeding, had been reversed on appeal. The petitioner claimed that he had been unable to appeal because of financial hardship, but the Court regarded the decision not to

¹¹² See also *United States v. Maryland ex rel. Meyer*, 382 U.S. 158 (1965), in which the Court granted leave to file a conditional petition for rehearing pending the Court's decision in *Maryland ex rel. Levin v. United States*, 381 U.S. 41, *vacated*, 382 U.S. 159 (1965), which involved a conflicting decision by another circuit growing out of the same accident, and then reversed after deciding *Levin*. The Court decided to hear both cases because they not only involved a common accident but were litigated on a single record. 381 U.S. at 43.

¹¹³ *Ackermann v. United States*, 340 U.S. 193 (1950).

appeal as a free choice and therefore fatal to his plea for relief.¹¹⁴ Thus, *Ackermann* involved disparate treatment of persons who not only were similarly situated but whose denaturalization decrees were issued in the same judicial proceeding, when little prejudice would have resulted to the prevailing party, the Government, had relief been granted.

The court in *Pierce* may also have been concerned with the element of free choice.¹¹⁵ The majority notes twice in its opinion that plaintiffs were "forced" into the federal forum where they could not utilize the "strategem" of urging that state precedent be overruled that the plaintiff employed in the state courts.¹¹⁶ Judge Barrett would have voted to deny relief had the plaintiffs chosen the federal forum in the first instance.¹¹⁷ In fact, Judge Barrett would grant rule 60(b)(6) relief to a party who did not voluntarily choose the federal forum whenever that party would have prevailed in state court, apparently even in an unrelated accident case.¹¹⁸

It is difficult to say, then, just what rule *Pierce* purports to announce. The mere fact of divergent results in state and federal courts in cases arising from the same accident, singled out by the majority as the distinguishing feature of the case,¹¹⁹ may not be sufficient to merit relief under rule 60(b)(6). The absence of free choice in being in the federal forum may have been a critical factor in the determination to grant relief. Countervailing considerations may require the denial of relief even in a related accident case. The presumption that the prevailing party's expectations of finality are weaker in a related accident case than in an unrelated accident case may be refuted by actions taken in reliance on the first judgment. In addition, when the party prevailing in the first decision in parallel suits growing out of a common catastrophe is not a party to the second suit, his expectations about the finality of his judgment are substantial, because litigation terminated for him with the first judgment. Finally, *Collins v. City of Wichita*,¹²⁰ distinguished in *Pierce* as a case involv-

¹¹⁴ *Id.* at 198.

¹¹⁵ In *Pierce* the absence of freedom was in the choice of forum, not the decision whether to appeal.

¹¹⁶ 518 F.2d at 723.

¹¹⁷ *Id.* at 724-25 (Barrett, J., concurring); see text accompanying notes 65 & 66 *supra*.

¹¹⁸ 518 F.2d at 724-25.

¹¹⁹ *Id.* at 723.

¹²⁰ 254 F.2d 837 (10th Cir. 1958).

ing unrelated transactions,¹²¹ concerned property rights whose existence in a case involving related transactions might make rule 60(b)(6) relief inequitable.

Although the decision in *Pierce* might not have been impeachable as an abuse of discretion if handed down by a district court, the decision of the court of appeals is not persuasive as a matter of law. It is by no means clear which facts, if any, constituted the extraordinary situation prerequisite to relief under rule 60(b)(6).

IV. CONCLUSION

Whether relief should be granted under rule 60(b)(6) when inconsistent results are reached in state and federal courts in suits arising from a common catastrophe is still an open question after *Pierce*. Such relief is not barred by the requirement that grounds for relief under clause (6) be exclusive of grounds covered by clauses (1)-(5), nor by the prohibition of the use of rule 60(b) as a substitute for appeal, if relief is granted after the case has been heard on appeal. On the other hand, such relief is not required by *Erie* beyond a limited time after entry of the judgment of a court of appeals, and within that time alternate remedies are available. Consequently, if an exception is to be made to the general rule against rule 60(b)(6) relief from judgments in a change of law situation, it must be based on equitable grounds. Although a presumption that expectations of finality are weak in common catastrophe litigation might weigh in favor of relief in a case like *Pierce*, a just decision can only be reached by a careful balancing of all the competing equities in a particular case.

¹²¹ 518 F.2d at 722-23.

BOOK REVIEW

THE UNCERTAIN SEARCH FOR ENVIRONMENTAL QUALITY. BY BRUCE A. ACKERMAN, SUSAN ROSE-ACKERMAN, JAMES W. SAWYER, JR., AND DALE W. HENDERSON. New York: The Free Press, 1974. Pp. x, 386. \$13.95.

Wallace E. Oates†

The growing concern with environmental protection has manifested itself in both the natural and social sciences in a concerted research effort to extend our understanding of ecological systems and to employ this knowledge in the design of policies for an improved environment. Biologists and chemists have labored, for example, to learn the dynamics of the processes of decay and assimilation of waterborne wastes in streams and rivers; at the same time, economists have turned their tools of applied welfare economics to the evaluation of policy alternatives for the preservation of water quality.

While all this is certainly commendable in itself, the trouble has been that the analyses forthcoming from these efforts have taken a highly technical form. The description of river dynamics (a "materials balance analysis") typically takes the form of a highly complex set of simultaneous differential equations. Likewise, the economist's "cost-benefit analysis" draws on a substantial set of often-implicit assumptions as well as extensive quantitative studies. Simply to understand the character of these analyses *and their limitations* requires considerable expertise.

How, then, can policy-makers, who are not technical experts, evaluate such analyses and incorporate them in an intelligent way into actual policy proposals? This, incidentally, is not simply a matter of following the prescription of an able technical adviser, for there are typically important value judgments and individual interests at stake; technical assistance is obviously important, but it is not the whole of the decision.

In addition to making technical analyses comprehensible, there is the closely related and crucial matter of the actual use of such analyses in the process of debate leading to the formulation

† Professor of Economics, Princeton University.

of an environmental program. How, for example, are these studies likely to influence not only the choice of method to achieve the environmental targets but also the selection of the objectives themselves? In short, the issue is how technical analysis itself interacts with the other elements of the decision process.

As a corollary to these problems of technical inputs, how can we design political institutions whose structure will embody the right sorts of incentives for environmental decisions? It is the rule rather than the exception that the natural boundaries for environmental control (water basins and air sheds) do not coincide with existing political jurisdictions. Is it enough simply to ensure that the decisionmaking authority includes representatives from the concerned states and federal agencies?

A recent interdisciplinary study centered at the University of Pennsylvania has produced a profoundly important exploration of these issues in terms of a detailed, thorough examination of the decisionmaking process that resulted in a major and costly program to clean up the Delaware River. The result is, in my view, the most significant book¹ yet written on the determination of environmental policy. The study, under the direction of Bruce Ackerman, is an example of what interdisciplinary research ought to be. Drawing on the technical expertise of natural scientists, economists, and lawyers, the Ackerman group undertook a painstaking three-and-a-half-year effort to understand the roles and interaction of those individuals, both scientists and politicians, whose influence came to bear on the choice of the Delaware program. The book is a fascinating description of this decisionmaking process along with a careful and judicious attempt to ascertain the lessons to be learned from the Delaware experience.

It is this second facet of the Ackerman study that yields something far more than merely an absorbing case study. At appropriate junctures, the authors step back from their analysis of the Delaware decision to consider what of a more generic nature can be gleaned from the proceedings.² And it is here that they can generate a series of insights into environmental decisionmaking that transcends the problems of the Delaware Estuary. The reader comes away from the book with a far deeper understanding of the complexities inherent in the application of

¹ B. ACKERMAN, S. ROSE-ACKERMAN, J. SAWYER, JR. & D. HENDERSON, *THE UNCERTAIN SEARCH FOR ENVIRONMENTAL POLICY* (1974) (hereinafter cited as B. ACKERMAN).

² *Id.* 67-78, 136-61, 208-20.

cost-benefit analysis and of the limitations of the much heralded "co-operative federalism" in resolving our environmental problems, an understanding greatly enhanced by "seeing" these techniques in action in the Delaware program.

To organize the discussion in this Review, I first describe briefly the institutional structure and proceedings for the Delaware enterprise.³ With this as background, I subsequently turn to three fundamental issues: the use of formal "modeling" and of cost-benefit analysis to define and evaluate the policy alternatives,⁴ the significance of the institutional structure for the choice and implementation of programs,⁵ and the selection of a form of regulation of polluters to achieve the designated standards for environmental quality.⁶

I. THE INSTITUTIONAL STRUCTURE OF THE DELAWARE PROGRAM

The principal actors in the Delaware drama composed two distinct groups. The first was an essentially technical staff supported by the federal Public Health Service to undertake an ambitious scientific analysis: the Delaware Estuary Comprehensive Study (DECS). Greatly intrigued by the appearance of cost-benefit analytical techniques in Washington in the early 1960's, the Public Health Service saw in the Delaware case an opportunity to push these new techniques into the field of water quality. In 1962 the Service launched, at a cost of \$1.2 million, the four-year DECS enterprise with the research under the direction of a young sanitary engineer, Robert Thomann, who had recently completed a doctoral thesis involving mathematical modeling of the effects of pollutants on estuaries. The DECS staff was eager to show how such scientific techniques could form the basis for decisions on water quality in an actual estuary.⁷

In contrast to the research-oriented DECS, there existed at the same time a decisionmaking body, the Delaware River Basin Commission (DRBC). Created in 1961, the DRBC was a new "model regional agency" with a constituency from the four interested states (Pennsylvania, New Jersey, New York, and Delaware) and the federal government. The Commission itself took an innovative form of "co-operative federalism": a regional body

³ Text accompanying notes 7-16 *infra*.

⁴ Text accompanying notes 17-61 *infra*.

⁵ Text accompanying notes 62-83 *infra*.

⁶ Text accompanying notes 84-111 *infra*.

⁷ B. ACKERMAN, *supra* note 1, at 12-13.

representing the interests of the concerned states and the federal government and endowed with broad decisionmaking powers for the development of the resources of the Delaware River. Moreover, the voting members of the DRBC were not obscure figures; they consisted of the governors of these four states and the Secretary of the Interior.⁸

The origin of both the DECS and the DRBC can be traced to a series of disastrous floods in the Delaware during the 1950's. These pointed up the need for a concerted effort for flood control of the Delaware's waters. This concern, however, soon expanded into a wider undertaking to investigate and control not only water quantity, but also its quality.⁹ This enlarged perspective received, moreover, a powerful impetus from the passage of the Federal Water Quality Act of 1965;¹⁰ the Act required the states to submit by June 30, 1967, a set of water quality standards and plans for implementation.¹¹

The new federal Act also ushered in a new relationship between the DECS and the DRBC. The Commission faced the difficult task of formulating a set of objectives and programs for water quality in the Delaware, but did not as yet possess an adequate technical staff or research effort to provide a sound and intellectually respectable foundation for such decisions. The DECS staff, however, was well along its way in the development of an operational model of the estuary to be accompanied by estimates of the costs and benefits of alternative water quality objectives.¹² The DECS clearly had what the DRBC needed.

To assist the Commission with its decisions, the DECS staff undertook to produce a preliminary report by mid-1966. This report summarized five potential water quality programs with varying objectives; using a cost-benefit analysis, the staff went on to estimate in dollar terms the benefits and costs associated with each objective set.¹³ I have reproduced these estimates as Table I.

What must be emphasized is that it was this set of choices summarized in Table I that came to be the frame of reference for the debate over the Delaware program. When the deliberations began among groups of concerned citizens, polluters, and

⁸ *Id.* 3-5.

⁹ *Id.* 11-12.

¹⁰ 33 U.S.C. § 466 (1970).

¹¹ *Id.*; B. ACKERMAN, *supra* note 1, at 13.

¹² B. ACKERMAN, *supra* note 1, at 13.

¹³ *Id.* 14.

TABLE I
COST-BENEFIT ANALYSIS OF DECS POLLUTION PLANS¹⁴

Objective Set	Cost	High Estimate-Low Estimate of Benefits
I	\$490 million	\$355-155 million
II	275 "	320-135 "
III	155 "	310-125 "
IV	110 "	280-115 "
V	30 "	—

the DRBC itself, attention was focused on *which* of the DECS objectives was the most appropriate.¹⁵ In the end, the DRBC adopted a slightly modified version of Objective II¹⁶ (which, incidentally, is considerably more ambitious than Objective IV, which produces the largest expected *net* benefit according to the DECS estimates). Important as the final choice may be, it is of far greater significance that *the technical staff of the DECS effectively defined the alternatives*. Just why this is so critical will become apparent in the next section, where we examine what lies behind the figures in Table I.

II. "MODELING" AND COST-BENEFIT ANALYSIS IN POLICY FORMULATION

The DECS staff had first to confront what is basically a definitional issue: the meaning (in measurable terms) of water quality. Opting for a widely used measure, the staff essentially chose the level of dissolved oxygen (DO) to serve as its "proxy" for water quality. In fact, the objective sets cited in Table I effectively represent differing levels of DO; Table II indicates this correspondence.¹⁷

The first issue this raises is the adequacy of DO as a measure of water quality. The DO content of a body of water certainly is of some significance: If, for example, the DO level "sags" suffi-

¹⁴ *Id.* 15.

¹⁵ See generally *id.* 13-14.

¹⁶ See *id.* 187. See generally *id.* 170-207.

¹⁷ Although the various objective sets did include goals for a number of other pollutants, the DECS staff never considered the costs of reaching any of these "secondary" goals independently of the DO objective. Letter from Susan Rose-Ackerman to Wallace E. Oates, July 20, 1975.

ciently low for an extended period, the waters can no longer support fish life.¹⁸ Moreover, should DO levels approach zero, a noxious process of "anaerobic decomposition" sets in with a vile discoloration of the waters and foul odors.¹⁹ This vitiates any recreational uses (or aesthetic value) of the river or lake.

TABLE II
AVERAGE DO IN PARTS PER MILLION IN MOST POLLUTED AREA
OF THE DELAWARE²⁰

Objective Set	Level of DO
I	4.5
II	4.0
III	3.0
IV	2.5
V	1.0

To prevent dissolved oxygen from falling to undesirably low levels, a river authority can undertake a number of measures. Most basic, however, is the control of the quantity and quality of those wastes that utilize oxygen in the process of decomposition; the oxygen consumption made by such wastes is typically measured in terms of its Biochemical Oxygen Demand (BOD).²¹ Programs to increase DO levels thus entail both reductions in organic wastes and treatment of such wastes to reduce the BOD emissions into the receiving waters.

While the DO level represents one important dimension of water quality, it is by no means the only significant characteristic. For example, another aspect of pollutants that poses an obvious threat is the toxic properties of certain inorganic wastes which can themselves render the water unsafe for drinking, swimming, or fishlife.²² In short, a certain DO content may be *necessary* to support fish and for certain recreational uses of the water, but it is not *sufficient*.

¹⁸ *Id.* 18.

¹⁹ *Id.* 18-19.

²⁰ *See id.* 32.

²¹ *See id.* 18-22. More precisely, the BOD of a waste discharge is the number of pounds of oxygen that will be consumed in the biochemical oxidation of the organic impurity present in the emission.

²² *Id.* 27.

Moreover, the authors point out some particular characteristics of the Delaware estuary that create considerable uncertainty about the gains from a program to increase levels of DO. One problem concerns the high levels of river turbidity, which give the water an opaque brown appearance with adverse aesthetic and recreational consequences.²³ It is not clear that a DO "cleanup" would have much effect on the turbidity; but if it did, the clearer water might well prove far more receptive to the growth of algae so that in the end it "may simply mean that the valley is trading a brown river for a green one."²⁴

In addition, the sludge deposits in the bottom of the Delaware support a large population of oxygen-consuming worms ("tubificid"). As DO levels increase, the authorities can expect a rapid multiplication of these worms with the associated rise in the "benthic oxygen demand" on the river's supply of oxygen.²⁵ The extent of these side effects is uncertain; the point, however, is that the ecology of a river like the Delaware is highly complex, and programs to alter one characteristic of the system are likely to have some additional and unexpected effects on other forms of water life.

Suppose that we push all this aside and accept, for the moment, the adequacy of dissolved oxygen as a measure of water quality for the Delaware. How well does the DECS model describe and predict DO levels in the Delaware estuary? The answer is, only moderately well at best. It must first be recognized that DO content is not a single number. The Delaware Estuary stretches about one hundred miles from Trenton to Liston's Point on the coast,²⁶ and its DO level exhibits wide variations over different spans of its flow. Rather than one level of DO, the oxygen content of the river is described by a "profile" which exhibits graphically the existing DO concentrations at each point along the river. Such a profile indicates a "sag" in DO immediately below Trenton which becomes even more accentuated downstream from Philadelphia. This, of course, reflects the decomposition of the relatively heavy waste emissions from both industrial sources and municipal waste treatment plants in these two areas of concentrated populations and industrial activity. To analyze DO levels, the DECS staff divided the river below Trenton into thirty sections; the DECS model thus aimed at describ-

²³ *Id.* 26.

²⁴ *Id.* 27.

²⁵ *Id.* 22, 51-53.

²⁶ *Cf. id.* 23-24.

ing and predicting DO concentrations in each of these thirty stretches of the river.²⁷

This is no easy task. The levels of DO depend not only on the quantities and quality of the wastes emitted at various points along the Delaware, but they are also crucially dependent on the level of the water flows,²⁸ on water temperatures,²⁹ and on wind velocities above the river surface.³⁰ DO is typically at its lowest levels during the hot summer months when the capacity of the river to assimilate waste discharges is at its minimum.³¹ Moreover, the water flows are complicated by the fact that the Delaware is an estuary and thus subject to influences from the ocean tides; BOD can flow upstream as well as downstream.³² Finally, during periods of heavy rain, the sewer systems of Trenton, Camden, Philadelphia, and Wilmington tend to overflow, pouring huge and unpredictable quantities of BOD into the Delaware; these overflows take place about ten days each year.³³

To keep the problem relatively simple and to reduce data requirements, the DECS staff chose essentially to ignore all these sources of variation over time and to assume a "steady state" condition;³⁴ that is, they assumed that "*relevant river conditions remained constant over time.*"³⁵ This is obviously a major simplification, but the critical question is the extent to which this assumption impaired the precision of the model's predictions.

Ackerman and his colleagues looked carefully at the performance of the DECS model and found substantial inaccuracies. In about one case out of three, the predicted DO content for a given sector of the Delaware differed from the actual level of DO by more than .5 parts per million.³⁶ This is not a minor imprecision, as a look at Table II indicates that this can represent the difference between one objective set and another at costs of possibly over one hundred million dollars.³⁷

²⁷ See *id.* 22-25.

²⁸ *Id.* 35.

²⁹ *Id.* 38.

³⁰ *Id.* 49-51.

³¹ *Id.* 38.

³² *Id.* 33-34.

³³ *Id.* 42-45.

³⁴ *Id.* 37-39.

³⁵ *Id.* 37 (emphasis in original).

³⁶ See *id.* 57-58.

³⁷ If Objective Set I is chosen, for example, the cost will exceed that of Objective Set II by \$215 million, see Table I *supra*; yet with a possible DO error of .5 parts per

Moreover, this appears to understate to some extent the full disparities between "actual" and "predicted" values of DO, for the DECS staff had itself previously adjusted some of the predictions in the light of excessive deviations from actual DO concentrations.³⁸

All this is not meant to understate the accomplishments of the DECS. The construction of an operational model of the Delaware represents a substantial achievement. The margins of error in the model's predictions, however, appear quite considerable, and this expected divergence of predicted from actual DO levels is a matter that the decisionmaking body should weigh with care. We shall return to this shortly.³⁹

The next step in the DECS analysis was to estimate the potential benefits from increased levels of DO and the costs necessary to achieve these improvements in water quality. At this juncture, the staff turned to the economist's technique of cost-benefit analysis,⁴⁰ an approach with a substantial history in the evaluation of water resource projects.

A cost-benefit study involves essentially four steps. The first is simply an enumeration of the various forms of benefits and costs inherent in the undertaking. In the case of the Delaware, the "tangible" benefits from a cleanup of the river were determined to consist primarily of an improved recreational potential: swimming, boating, and fishing.⁴¹ To achieve these benefits, it would be necessary to reduce levels of waste discharges into the river with consequent higher costs to polluters who would have to adopt more expensive alternatives in order to reduce the quantity and/or improve the quality of their waste emissions. The costs of the Delaware program were thus primarily the additional expense in cutting back on wastes and increasing the levels of treatment.

The second step is the assignment of actual dollar values to the various forms of benefits and costs. The DECS staff undertook an extensive questionnaire study of the forty-four major polluters along the Delaware estuary to collect information for the estimation of the costs of reduced BOD emissions.⁴² At the

million we have no guarantee that the DO level will exceed that available under the rejected Objective Set II, *see* Table II *supra*.

³⁸ B. ACKERMAN, *supra* note 1, at 59-61.

³⁹ Text accompanying notes 54-55, 59-60 *infra*.

⁴⁰ For a comprehensive treatment of cost-benefit analysis, *see* E. MISHAN, *COST-BENEFIT ANALYSIS: AN INFORMAL INTRODUCTION* (2d ed. 1974).

⁴¹ B. ACKERMAN, *supra* note 1, at 102.

⁴² *Id.* 85-86.

same time, a range of estimates was made for the benefits from expanded recreational uses.⁴³

The third step involves the selection of an appropriate rate of discount for the evaluation of benefits and costs that are expected to accrue in future years. The point is, simply, that 100 dollars in benefits or costs one year hence is worth less than 100 dollars at the present moment; with positive rates of return (interest), 100 dollars today is worth 100 dollars *plus* the accrued interest at some future date. If, for example, we adopt a discount rate of six percent, we are effectively saying that we will assign a "present discounted value" of 100 dollars to a sum of benefits (or costs) of 106 dollars to be realized one year in the future. The final step in the cost-benefit study is simply to take our time profile of dollar benefits and costs along with the chosen rate of discount and then to calculate the present discounted value of the entire expected future stream of benefits and of costs. These are the numbers presented in Table I above, where the DECS staff used a discount rate of three percent.

Although the general cost-benefit approach seems quite straightforward, there are in fact a number of problems or ambiguities, both in principle and in practice. There are effectively two sets of issues at stake. The first is the assumptions inherent in the cost-benefit technique itself, and the second is the particular procedures employed by the DECS staff to reach the estimates of the benefits and costs of the selected set of objectives for the Delaware. I will comment only briefly on these two matters, for the most fascinating dimension of the book goes beyond the content of the DECS cost-benefit study to the *way* in which the study was employed in the decision process.

The authors set out carefully and lucidly for the non-specialist the nature of cost-benefit analysis.⁴⁴ In particular, it is important to recognize just what the cost-benefit test is. In computing the value of the benefits and costs associated with a particular project, the assignment is determined upon the basis of people's "willingness to pay." The cost-benefit test is effectively an attempt to apply market criteria to the evaluation of public projects. When the researcher calculates and compares the present discounted value of the expected future stream of benefits with that of costs, he is asking the question: Does the value of the undertaking, *as measured by what people would be willing to pay*,

⁴³ *Id.* 102-03.

⁴⁴ *Id.* 104-09. See generally E. MISHAN, *supra* note 40.

exceed (or, alternatively, fall short of) its costs, again measured in terms of actual or imputed market prices? The cost-benefit test is thus an analogue to the profit test in the market place, for it measures whether, in principle, there could be sufficient revenues (if people were to pay for the benefits) to cover costs.

Seen from this perspective, we can determine what a cost-benefit test does *and does not* tell us. It does not, for example, indicate to whom the benefits accrue or who bears the costs; it is an aggregative test in the sense that benefits and costs are summed over all persons. This immediately suggests that although the cost-benefit test may supply some valuable information, it is not in itself the sole criterion on which to base project decisions.

Environmentalists, in particular, have raised a second objection to the application of the cost-benefit approach: its exclusively anthropomorphic perspective.⁴⁵ The benefits and costs that enter the calculations are the valuations to human beings. But should not some weight be given to the shad or other wildlife whose well-being is at stake? Does man have the right to destroy animals for his own purposes? This involves some tricky philosophical issues—in the end, for example, men will make the decision and it must, therefore, be men's valuation of the interests of wildlife that is relevant. Nevertheless, one can still argue that man has certain responsibilities or interests regarding the "integrity of nature" that extend beyond the scope of conventional cost-benefit calculations.

In addition to these matters of principle, Ackerman and his colleagues explore carefully the specifics of the DRBC cost-benefit study. Here again they find a number of important anomalies and, in some instances, outright errors. From the outset, the DECS staff carried over all the simplifications in the Delaware model to the cost-benefit calculations; the computations, for example, refer only to the attainment of alternative levels of dissolved oxygen.⁴⁶ The valuations of benefits and costs are thus themselves subject to all the reservations cited earlier in this section.

Moreover, the authors find that the DECS estimates of the costs of pollution control were far too low, while (largely because of a conceptual error) the benefits appear somewhat exaggerated. In particular, an underestimate of costs resulted, first from

⁴⁵ See B. ACKERMAN, *supra* note 1, at 138-42.

⁴⁶ Thus the benefits are expressed as correlates for DO Objective Sets I-IV, *compare id.* 103, at Table 4 with *id.* 15, at Table 1, *id.* 32, at Table 2, and *id.* 63, at Table 3.

restricting the study to the forty-four major point-source polluters who account for about two-thirds of BOD emissions⁴⁷ and, second, from an inadequate provision for the growth in emissions over time.⁴⁸ Some later revised estimates of the costs of dealing with anticipated increases in wasteloads pushed the price from 20 million to 140 million dollars; by this time, however, certain commitments had been made on the basis of earlier estimates, and officials apparently were quick to suppress these new and potentially embarrassing cost overruns.⁴⁹

On the benefit side, the DECS calculations were based on existing estimates of the "intrinsic" value (in dollar terms) of a day of fishing, boating, or swimming, multiplied by a predicted number of users.⁵⁰ This measure of benefits, however, is highly misleading; the cost-benefit analyst seeks to measure the value of the new facilities in terms of what consumers would be willing to pay rather than do without them. This implies that the benefits from the new recreational opportunities must be evaluated relative to already existing facilities. The proper basis for valuation is not one of the intrinsic worth of a day of fishing, but rather the value to fishermen of having the Delaware available in addition to existing fishing sites.⁵¹ This methodological bungle (for which, incidentally, there is considerable precedent)⁵² probably imparts a substantial upward bias to the DECS estimates of benefits.

With this as background, we can now turn to the most fascinating part of the Delaware story: the way in which the DECS cost-benefit study figured in the deliberations on and ultimate choice of the Delaware program. The preceding paragraphs indicate the substantial degree of imprecision and uncertainty inherent in the DECS estimates of the benefits from and costs of a cleanup of the Delaware; the sweeping, simplifying assumptions and the limited availability of critical information suggest that the findings should be couched in terms of a number of qualifications and warnings. But this is precisely the opposite of what happened. In their eagerness to impress the outside world with their accomplishment in constructing an operational model of the Delaware and using this model to derive actual dollar estimates of the benefits and costs of various programs, the DECS

⁴⁷ *Id.* 85-86.

⁴⁸ *Id.* 86-90.

⁴⁹ *Id.* 94-96.

⁵⁰ See generally *id.* 124-32.

⁵¹ See *id.* 115-19. See also *id.* 109-15.

⁵² Mack & Meyers, *Outdoor Recreation*, in *MEASURING BENEFITS OF GOVERNMENT INVESTMENTS* 71-116 (R. Dorfman ed. 1965).

staff produced a report that hardly even hinted at the imprecision inherent in the predictions of the model and the associated estimates of benefits and costs.

In short, the basic failing of the DECS Report was not so much that it failed to achieve a degree of comprehensiveness and exactitude that is never achieved outside the most fantastic science fiction; what was seriously defective was the manner in which the DECS Report understood the very idea of "achievement." The DECS succeeded insofar as it developed a set of equations defining a system that accurately described a small piece of reality. Thus, in emphasizing its achievement, the research staff emphasized the accuracy of the numbers its model generated. While this may be fine in a scientific forum in which the findings will be scrutinized by other experts concerned with the development of truth within a single disciplinary speciality, it is nothing short of disastrous when the same attitude is transposed into the policy-making arena.⁵³

More basic is the effect the DECS study had on the actual deliberations and the ultimate decision. As noted above,⁵⁴ the DECS findings, summarized in Tables I and II, for all practical purposes defined the alternatives. The debate among both interested citizens and the DRBC amounted to haggling over the appropriate objective set from these tables; in short, the DECS effectively channeled the discussion into a consideration of the proper level of dissolved oxygen.

This is enormously important, for it means that, from the outset, public discussion took the narrowest of perspectives. In the view of the authors, the real questions of strategy for an environmental program were eclipsed by the DECS report; Ackerman and his colleagues argue quite persuasively that the likely benefits from the costly Delaware program will be miniscule:

It is easy to imagine that when society decides to spend almost three quarters of a billion dollars to clean up a 40-mile stretch of river, something significant will come of it. The mind rebels at the thought that such vast sums are spent in vain. Yet in 1978, or 1980 or 1984, when the DRBC announces that it has "suc-

⁵³ B. ACKERMAN, *supra* note 1, at 65-66.

⁵⁴ Text accompanying note 15 *supra*.

ceeded" in achieving its DO objectives on the river, the Delaware will be just as cloudy as it ever was; it will be just as difficult to obtain access to the river; boating will be neither better nor worse than it was; the drinking water will taste the same as it always did. *Perhaps* good fishing will be a few minutes closer, and during some years more shad will "survive" their journey up and down the river. Is this what all the talk about improving "the quality of life" amounts to?⁵⁵

The authors contend that primary attention ought to be "focussed on the discharge of exotic chemicals and heavy metals which may pose a real risk to human health when present in drinking water or in seafood";⁵⁶ the first priority here is the avoidance of ecological catastrophe. Yet this seemed to have generated little concern among the DECS staff.⁵⁷ As to environmental protection generally, Ackerman and his colleagues see little to be gained from extensive and costly efforts to rehabilitate heavily used water systems; instead, they argue that the general strategy should be to preserve those resources as yet relatively unspoiled by twentieth-century life.⁵⁸ Rather than attempting at great expense to raise the level of DO in the Delaware around Trenton and Philadelphia, we would do better to preserve the lower estuary from the incursion of sources of pollution.

Whether or not they are correct on this basic issue of environmental strategy, it is striking that in the course of the Delaware deliberations this matter was never even acknowledged!⁵⁹ The force of the DECS preliminary report was such as to sidetrack the discussion from a consideration of the real alternatives to a relatively trivial controversy over whether the DO level would be brought to 2.5 or 3.0 parts per million. And the ultimate outcome may well be, as the authors suggest,⁶⁰ an extremely expensive program with little noticeable effect on the quality of the Delaware's waters.

What are we to conclude from all this? It seems to me that a reader's first reactions may be of two general kinds. One may conclude that the real trouble rests in the DECS analysis; if the technical staff had simply adopted a broader perspective on the

⁵⁵ B. ACKERMAN, *supra* note 1, at 142 (emphasis in original).

⁵⁶ *Id.* 145.

⁵⁷ *Cf. id.* (noting DRBC and general national inattention to poisons discharges).

⁵⁸ *E.g., id.* 137, 140, 144-45.

⁵⁹ See generally, *e.g., id.* 145.

⁶⁰ Text accompanying note 55 *supra*.

environmental alternatives and at least made clear the basic qualifications to their findings, we might have expected a far more enlightened public discussion and a more informed choice of a Delaware program. In short, what was needed was a better Delaware model and cost-benefit study. One may, on the other hand, take a more pessimistic stance and reason that such analyses are likely to be more misleading than helpful, that we would do better to give up attempts aimed at "sophisticated" definitions of the problem and at quantification and leave the decision to the judgment of the responsible bureaucrats and elected officials.

Neither of these reactions, however, seems to me the proper inference. It is too easy simply to put all the blame on the DECS study. There were obviously a multitude of serious deficiencies in the analysis *and* in its presentation, and we could certainly look to improved analytical studies to provide a better foundation for public debate. But even if the technical work is of a high quality, there remains the very formidable problem of its transmission in a usable form to decisionmakers. In particular, the nature of analytical studies and the needs of the political decisionmaker seem to verge on incompatibility: Analysis involves simplification which in turn implies important qualifications to any findings, while the political participant is seeking a position or decision he can take without fundamental ambiguities. I do not want to suggest that this is an insurmountable obstacle: We have, for example, benefited greatly from the use of analytical work in determining macro-economic policy. The tension (and the compromises) between the informational needs of the political process and the tentative character of analytical findings and predictions, however, surely exists.

Conversely, it really does not make much sense to abandon analytical studies of policy alternatives. As the authors put it,

When confronted with this precis, the reader is doubtless tempted to conclude that the DECS exercise, when properly understood, contributed nothing of value to a more precise understanding of the problems confronting the sensitive decision maker. But this would be a mistake; for it is only as a result of our effort to trace the DECS' investigations that it has been possible to obtain a perspective on the probable consequences of the costly program of pollution control which the DRBC has adopted. Our basic complaint does not go to the wisdom of the effort at sustained understanding of

river dynamics but to the way in which the DECS staff chose to *translate their insights into language comprehensible to decision makers*.⁶¹

Where this discussion leads is not to the abolition of policy analysis but rather to a study of institutional structure. The basic issue is the formation of a set of decision procedures that, first, will pose the proper questions, and, second, will generate and bring to bear the relevant kinds of information and analysis. It is to this matter of institutional structure that we turn next.

III. THE DESIGN OF INSTITUTIONS FOR POLICY DECISIONS

The Delaware experience also represents an innovative venture in "cooperative federalism." Not only was the decisionmaking body, the DRBC, composed of prestigious representatives from both the federal government and the concerned states, but federally supported technical assistance from the DECS staff provided, as we have seen, the basic research capability for the undertaking. How well did this institutional structure fulfill its role?

The authors have grave reservations about the division of the research and decision functions between the DECS (the "thinkers") and the DRBC (the "doers").⁶² The problem is best seen by considering the incentives confronting each agency and following through the likely implications. From the standpoint of the federally supported DECS, the basic enterprise was one of implementing *and* selling a highly complex and sophisticated form of environmental analysis. For the staff of the DECS, the Delaware study presented an opportunity to demonstrate the effectiveness of an innovative technique. With this perspective, such a "pure thinking agency may be expected . . . to justify its existence by overselling the accuracy and importance of its preliminary reports by underemphasizing the uncertainties underlying its predictions."⁶³

Moreover, the "thinking agency" is unlikely to have a long-term commitment to the program. The DECS staff would realize the bulk of their returns in the short run from the establishment of a basic analytical framework and from the initial results, not from the longer and more mundane efforts to accumulate basic and improved data and to follow up and refine the results.⁶⁴

⁶¹ B. ACKERMAN, *supra* note 1, at 64 (emphasis in original).

⁶² The authors so label the two agencies, *e.g.*, *id.* 74.

⁶³ *Id.* 74.

⁶⁴ *Id.* 74; *cf.* text accompanying note 7 *supra*.

In contrast, the orientation of the "action agency" is toward the implementation of a program. This agency, in our case the DRBC, typically requires the assistance of a technical body of some sort to help in the formulation of the program and to provide a kind of intellectual respectability.⁶⁵ But once the fundamental program is outlined, the action agency, like the thinking agency, is interested in selling the program, not in pointing up existing uncertainties or qualifications;⁶⁶ the decisionmakers can thus be expected to reinforce the tendencies of the research group to stress the precision and reliability of the plan. Moreover, once the action agency has implemented the program, its concern will be primarily with the enforcement of the plan, rather than with continuing basic research aimed at future planning efforts.⁶⁷ This bifurcation of responsibility appears to discourage follow-through on the basic planning efforts.

The DECS and DRBC seem to have followed this pattern of behavior quite closely. I have already stressed the exaggerated level of precision in the DECS reports.⁶⁸ In addition, the research effort apparently lost most of its vitality following the publication of the DECS preliminary report in 1966. The preliminary report promised a definitive "final document" by the end of 1967, a document which has yet to be published.⁶⁹ With the completion of the preliminary report, there was a shift of the basic research and planning function from the federally supported staff to the regional level.⁷⁰ Although there was much additional work to be done in extending the DECS model and developing a more comprehensive and reliable data base, little seems to have followed on the preliminary report. In fact, the data-collection effort is at present so sporadic and generally inadequate as to preclude further effective research aimed at improving the predictive capability of the model.⁷¹

From this experience, Ackerman and his colleagues conclude that

The course of events along the Delaware eloquently warns against placing the federal "thinkers" in one bureaucratic box, then shifting the responsibility for

⁶⁵ Cf. B. ACKERMAN, *supra* note 1, at 74-75.

⁶⁶ *Id.* 75.

⁶⁷ *Id.*

⁶⁸ Cf. text accompanying notes 26-38 *supra*.

⁶⁹ B. ACKERMAN, *supra* note 1, at 68-69.

⁷⁰ *Id.* 69.

⁷¹ See *id.* 69-73.

scientific follow-through to the regional "decision-making" agency, simultaneously consigning the task of data gathering to yet another set of state agencies. In such a structure each component is prone to lose sight of the function it should be performing to enhance the rationality of the pollution control scheme that is the ultimate product of all the sound and fury.⁷²

The implication of all this would seem to be that the decisionmaking agency should have within its own organization the basic research capability. This too presents difficulties, however; in particular, the control of the agency's officials over the research personnel may serve to inhibit critical evaluations of existing policies.⁷³ At least the division of functions in the Delaware provided a certain protection and scope of independence for the DECS staff.

There seems to be no easy resolution of the dilemma. After considering a number of alternatives, the authors propose the creation of a new body: an Environmental Review Board.⁷⁴ The Board's function would be to provide an outside, independent assessment of each agency's environmental planning efforts. With a "quasi-judicial independence" from the executive and legislative branches of the government, the Board would scrutinize and evaluate basic environmental plans to ensure that the proper alternatives have in fact been posed *and* that the analysis of the alternatives is sound.⁷⁵ In the case of the Delaware, for example, such a Review Board would presumably have required a broadening of the perspective beyond just the DO level of the estuary, as well as the resolution of certain anomalies in the basic model and the cost-benefit analysis. The potential for such a review body is, I think, considerable; our closest relative to the proposed Board has probably been the General Accounting Office (GAO), several of whose reports have been extraordinarily revealing.⁷⁶ Simply the existence of such a reviewing agency keeps people on their toes with the knowledge that a shoddy job of analysis may easily be exposed.

⁷² *Id.* 77.

⁷³ For an account of the conflict between DECS and DRBC, see *id.* 191-93.

⁷⁴ *Id.* 156-61.

⁷⁵ *Id.* 156-57.

⁷⁶ See, e.g., COMPTROLLER GENERAL OF THE UNITED STATES, EXAMINATION INTO THE EFFECTIVENESS OF THE CONSTRUCTION GRANT PROGRAM FOR ABATING, CONTROLLING, AND PREVENTING WATER POLLUTION (1969) (critical review of federal program for subsidizing construction of municipal waste treatment facilities).

Let us turn next to the decisionmaking process in the DRBC itself. Through a lengthy series of interviews with the actual participants in the DRBC decision and a study of associated written documents, the authors found a number of recurring patterns of behavior which again cast considerable doubt on the efficacy of some of the new forms of cooperative federalism. Without trying to recapitulate the positions and roles of the individual Governors, the Secretary of the Interior, and others with some influence in the decision process, let me simply highlight some of these tendencies.⁷⁷ The central difficulty stems from the basic and obvious fact that the primary political commitment of each of the participants is to a constituency other than the regional agency itself. The interviews and proceedings made clear that what was uppermost in the minds of each of the members of the DRBC was how best to further his own interests *in terms of his own political jurisdiction*.⁷⁸ This meant, among other things, that these extremely busy political figures were able to devote little effort to an understanding of the distinctly regional dimensions of the Delaware problem. They turned for advice to their own political advisors with the result that a truly regional orientation never developed in the DRBC.⁷⁹

It is not surprising that when it came time to take a position on the Delaware program, each participant consulted his own political calculus. As the Delaware experience makes clear, however, the inevitable compromise that emerges from such an amalgamation of varying interests may bear little resemblance to an effective regional program.

The technocratic-political decision, whatever its ultimate value, requires tight integration among fact finders, analysts, and politicians. In contrast, federalism is instinct with the demand that power be fractionalized among competing groups and levels of government, and the suspicion that a coherent, tightly organized governing structure will by virtue of that single fact possess too much power and so act irresponsibly. Unfortunately, the federalist effort to eliminate the possibility of the abuse of power can often make it impossible to use power intelligently as well.⁸⁰

⁷⁷ For a full discussion of the political maneuvers accompanying the DRBC's adoption of the DECS Objective Set II, see B. ACKERMAN, *supra* note 1, at 170-89.

⁷⁸ See *id.* 182-87.

⁷⁹ See *id.* 193-200.

⁸⁰ *Id.* 189 (footnote omitted).

There is, moreover, no obvious way to resolve this fundamental dilemma of American federalism. One potential response would be the creation of a new layer of government: regional political bodies to address explicitly regional issues. But it is difficult to be sanguine about imposing yet another set of bureaucracies and associated political activities on the American system. The authors explore a number of institutional alternatives and offer several provocative proposals. Their approach is essentially to distinguish among various environmental issues according to the sorts of geographical and institutional demands they make on our public institutions. As they see it, the most promising response would involve some national agencies—a Poison Control Board⁸¹ and a Nature Preservation Trust⁸²—along with some regional and perhaps metropolitan units to protect and develop recreational facilities.⁸³ These proposals, however, are an exploration of various responses to an enormously complex set of issues rather than a definitive blueprint for a set of public institutions for the formulation and implementation of environmental policies.

IV. LEGAL-ORDERS VERSUS REGULATION BY MARKET INCENTIVES

In the last section of this Review, I want to examine another set of problems with somewhat more economic content: the method of regulating waste emissions. Once the environmental targets are specified, it becomes necessary to design and implement a program to achieve them. In the case of the Delaware Estuary, we have seen that the designated objective was a certain minimum level of dissolved oxygen.⁸⁴ To attain this target, the environmental authority faced the problem of allocating emission quotas among polluters so as to restrict waste discharges to a level consistent with the prescribed level of dissolved oxygen.

The authors' analysis of this issue is most illuminating. In principle, there were two broad options available to the DRBC. The first is "regulation through legal orders." This, in fact, has been the traditional approach: The authority issues orders to each of the polluters specifying a limit to his waste emissions and indicating certain penalties if this limit is exceeded.⁸⁵ There is,

⁸¹ See *id.* 209-10.

⁸² See *id.* 214-15.

⁸³ See *id.* 210-13.

⁸⁴ Text accompanying notes 17-21 *supra*.

⁸⁵ See *id.* 225-26.

however, a second general technique for controlling levels of emissions, which the authors call the "market model" of regulation. This approach involves the use of pricing incentives to "ration" the available pollution rights.⁸⁶

Economists have, for many years, been pressing the case for price incentives.⁸⁷ And the Delaware experience adds substantial support to this case. The basic appeal of the pricing approach is its potential for achieving the environmental objective at relatively low cost and doing so without making major demands for information or intervention on the part of the regulating authority. In principle, the regulator need only set a price or charge on the BOD content of waste emissions and adjust this charge until polluters cut back waste emissions to the target level.

In addition to its (at least apparent) simplicity, the pricing technique can result in large savings. Suppose, for example, that we have a world of two polluters in which the first can reduce waste emissions at a cost of five cents per pound while the second suffers a cost of twelve cents per pound. To minimize the cost of a reduction in total waste emissions, we would obviously assign the entire cutback to the first polluter, for any cutbacks by polluter number two would involve an "excess" cost of seven cents per pound. Note that this is precisely what would happen under a pricing regime: If, for example, the regulator set a price of six cents per pound, all the reduction in waste emissions would come from the first polluter; the second would pay the charge of six cents per pound and maintain his level of waste discharges.⁸⁸ More generally, in a model with many polluters, a single uniform charge will lead to the least-cost pattern of reductions in emissions: Those who can cut back on effluents most cheaply will do so to avoid the charge, while those polluters for whom this is very costly will elect instead to pay the effluent fee.⁸⁹

⁸⁶ See *id.* 226.

⁸⁷ This dates at least to A. PIGOU, *THE ECONOMICS OF WELFARE* (1920). For a sampling of more recent literature, see W. BAUMOL & W. OATES, *THE THEORY OF ENVIRONMENTAL POLICY: EXTERNALITIES, PUBLIC OUTLAYS, AND THE QUALITY OF LIFE* (1975); A. KNEESE & B. BOWER, *MANAGING WATER QUALITY: ECONOMICS, TECHNOLOGY, INSTITUTIONS* (1968); Freeman & Haveman, *Clean Rhetoric and Dirty Water*, *THE PUBLIC INTEREST*, Summer 1972, at 51.

⁸⁸ See B. ACKERMAN, *supra* note 1, at 260-61.

⁸⁹ This is a somewhat oversimplified example. In general, the cost per pound of reduction in emissions will depend on the magnitude of the cutback; this, however, does not impair the generality of the argument since each polluter will reduce his waste discharges to the point where the cost of an *additional* pound's reduction (the marginal cost) equals the effluent fee.

One most interesting output of the DECS mathematical model of the Delaware was a set of estimates of the costs of achieving the various objectives by alternative regulatory techniques. The DECS staff found, for example, that a set of legal orders imposing a uniform percentage reduction on the emissions of all polluters sufficient to achieve the DRBC objective (that is, Objective Set II) would entail an estimated treatment cost of 335 million dollars as compared to a cost-minimizing allocation of reductions of 235 million dollars—an “excess” cost of 100 million dollars!⁹⁰

This finding becomes of more than hypothetical significance in the light of the actual course of events. The DRBC elected the traditional regulatory approach: a system of legal orders to all polluters.⁹¹ They were well aware, however, of the cost-minimizing potential of varying the quotas among polluters. In particular, the DRBC sought to realize a large portion of these savings by dividing the eighty-six-mile estuary into four zones and assigning different percentage reductions in wastes for each zone, a “zoned-uniform percentage treatment plan.” Once the differences in costs implied by the recommended zonal differentials became clear, however, the DRBC was quick to narrow the variation, presumably in the interests of fairness and consensus, until in June, 1968, they promulgated emission reductions for the four zones of 86.0, 89.25, 88.5, and 87.5 percent.⁹² The authors conclude that “the DRBC four-zone scheme was nothing more than a public relations triumph, masking a traditional uniform treatment regime. . . . [T]he retreat [of the DRBC] represents a dramatic example of the difficulty of taking even modest steps toward cost minimization when constrained by the traditional version of the legal orders model.”⁹³

Even these guidelines proved terribly difficult to implement. The appeal of uniform percentage reductions for all polluters is some notion of fairness or equity based on “equal effort.” But uniform percentage reduction from what? Surely a refinery that has already instituted extensive and costly treatment procedures should not be required to reduce its emissions by the same proportion as a neighbor who has been emitting untreated wastes into the river. To deal with this issue, the DRBC staff had to undertake the enormously complex task of determining the

⁹⁰ B. ACKERMAN, *supra* note 1, at 230, Table 7.

⁹¹ *Id.* 231.

⁹² *Id.* 234-35.

⁹³ *Id.* 235-36.

hypothetical "raw waste load" for each major polluter to use as a benchmark for determining its pollution quota.⁹⁴ The authors document some of the anomalies that emerged in this case-by-case determination.⁹⁵ In particular, their Table 8⁹⁶ indicates a range of pollution quotas for different refineries (from 692 to 14,400 pounds of BOD per day) that would probably be difficult to reconcile with any reasonable standard of equity. In short, the legal-orders regime produced an allocation of pollution quotas that appears excessively costly and bears little relation to the "equal effort" principle of fairness.

This experience would seem to make the alternative approach of relying on market incentives all the more attractive. Under this general rubric, however, the environmental authority has two further options. The first is the imposition of effluent charges to induce the necessary reductions in waste emissions.⁹⁷ The second is the sale or auctioning of "pollution rights."⁹⁸ In principle, both lead to the same outcome: With effluent charges, the regulator raises the fee until the target level of emissions is achieved (he sets the price at the level required to realize the desired quantity); under the pollution-rights scheme, the regulator offers for sale emission rights equal in total to the target level (he sets the desired quantity directly and then lets price adjust to the market-clearing level). This is easily seen in Figure I, where DD^1 is the polluters' demand curve for emission rights and Q_0 is the target level of waste discharges. Under a system of effluent fees, the environmental authority would establish a

FIGURE I

⁹⁴ *Id.* 248-53.

⁹⁵ *Id.* 253-57.

⁹⁶ *Id.* 254.

⁹⁷ *Id.* 260-61.

⁹⁸ *Id.* 261.

price of P_0 to which polluters would respond by emitting wastes of Q_0 . Alternatively, the authority could simply sell Q_0 of pollution rights for which the market-clearing price would be P_0 .

While these two techniques yield the same result in principle, they have some important differences in practice. In particular, the use of effluent charges involves an element of risk and, perhaps, delay that is not inherent in the pollution-rights method. The difficulty is the imprecision in the authority's knowledge of the demand curve: with only rough estimates of the likely response of polluters to differing levels of charges, the regulator may set a fee other than Figure I's P_0 , as a result of which either too much or too little pollution (relative to the target Q_0) will occur.⁹⁹ Of course, the environmental authority can make subsequent adjustments to the effluent charge in a process that should converge to the target level of emissions, but this may take time.¹⁰⁰ Moreover, continuing adjustments in charges and levels of emissions are costly to firms and other polluters, as well as politically unpopular.¹⁰¹ In contrast, if the regulator simply sells the targeted quantity of pollution rights, this source of uncertainty and adjustments is eliminated. Since the objective is a specified level of waste emissions, the authority can set this directly by specifying quantity.¹⁰²

In addition, the authors point to the administrative advantages of the pollution-rights technique in the context of a growing economy. Over time, with the expansion of the economy and industrial activity, we can expect the cost of treatment necessary to maintain a specified level of water quality to grow; new plants

⁹⁹ *Id.* 262-63, 265-67.

¹⁰⁰ *Id.* 263.

¹⁰¹ *Id.* 268.

¹⁰² *Id.* 267. By eliminating the uncertainty regarding the *quantity* of emissions, however, the pollution-rights technique necessarily introduces uncertainty concerning the market-clearing price. This may not, incidentally, be a trivial matter. Suppose, for example, that x pounds of BOD emissions have been offered for sale, but that the issue of 1,000 additional pounds of emission licenses would make possible a substantial saving in abatement expenditure (and perhaps release to society resources that could instead be used to build schools and hospitals) with only a very minimal effect on environmental quality. Then the decision to issue only x (rather than $x + 1,000$) pollution rights would have imposed a heavy cost on society, one very likely unforeseen by the environmental authority. The grounds for the choice between the use of fees and the auctioning of pollution rights may then be a matter of which risk constitutes the greater danger. If unanticipated emissions are the most imminent threat to the public welfare, that argues for the auction of rights, which leaves little doubt about the probable volume of pollution. On the other hand, if pressing alternative uses for society's resources mean that excessive outlays on pollution control are a luxury that society can ill afford, then the fees approach, with its firmer control of abatement outlays, may be the preferable procedure.

will appear and the tendency will be toward expanding waste emissions. With a *given* effluent charge, emissions will rise and water quality will deteriorate.

Of course there is nothing to prevent an aggressive authority from raising the charge whenever this is appropriate. Nevertheless, . . . an effluent fee system will place *the burden of affirmative action* to maintain the agency's original environmental objectives *on nonpolluting river users*. In contrast, under the effluent rights system, the maximum permissible discharge is fixed at the time of the original decision, and the costs of growth will be borne only by polluters who will bid the price of the rights up over time. Thus, the rights system places *the burden of affirmative action on the polluters* to convince the agency that the increasing marginal compliance costs so outweigh the marginal environmental benefits of the status quo that some degradation below current levels should be permitted and additional rights issued.¹⁰³

For these reasons and others, the authors endorse a pollution-rights scheme as the most promising means for controlling waste discharges.¹⁰⁴ While this is by no means a new proposal,¹⁰⁵ it is not (to my knowledge) one that has really been considered very seriously at the policy level, and this is unfortunate. Perhaps this is because the proposal sounds strange: "The auctioning of pollution rights" has an almost otherworldly (Utopian or Satanic) ring.¹⁰⁶ Although unfamiliar, I would suggest that it is quite workable: Once having determined the acceptable level of waste emissions, I see no insuperable barrier to the allocation of quotas by sale rather than by the elaborate, and ultimately unsatisfactory, legal-orders method followed by the DRBC.

For my own tastes, I would be delighted with the introduction of either effluent charges or pollution rights into the pursuit of our environmental objectives. Either technique would represent an enormous improvement over the costly, and often largely ineffective, legal-orders tradition which has dominated

¹⁰³ *Id.* 269-70 (emphasis in original) (footnotes omitted).

¹⁰⁴ *Id.* 281. *But see id.* 275-81.

¹⁰⁵ *See, e.g., J. DALES, POLLUTION, PROPERTY, AND VALUES* (1968).

¹⁰⁶ *See generally* B. ACKERMAN, *supra* note 1, at 276-78.

environmental policy in this, and most other,¹⁰⁷ countries. While there is mounting evidence that pricing incentives are an efficient *and* highly effective means for controlling water pollution, air pollution, and the generation of solid wastes,¹⁰⁸ there remains a latent hostility to any technique that explicitly recognizes "pollution rights" or the desirability (in view of the costs) of maintaining positive levels of various polluting activities.¹⁰⁹

I do not want to leave the impression that the authors (or I) see the "market model" as the sole answer to our environmental problems. In fact, one of the most impressive aspects of this study is its painstaking effort to assess both the advantages *and disadvantages* of the various policy alternatives. The market model, if used *alone*, suffers from some serious deficiencies. (For example, there is the problem of coordination: Economies of scale in treatment may dictate the need, in certain instances, for joint planning and use of facilities; but it is not clear that voluntary action on the part of individual polluters will result in the establishment of such facilities in the most advantageous locations.¹¹⁰ Moreover, some effluents may be so dangerous to human life that their discharge should simply be banned altogether.¹¹¹) The point is rather that a heavy reliance on price incentives should constitute an integral part of an overall environmental strategy. Unfortunately, we have to this point chosen to ignore this potentially powerful instrument for protection of the environment.

V. CONCLUSION

The authors conclude their study on a relatively pessimistic note as regards the formulation and implementation of an effective environmental policy.¹¹² The Delaware experience not only indicates the deficiencies in a single episode of analysis and decisionmaking, it also reveals a series of extremely complex and troublesome obstacles inherent in the very process of instituting a sensible environmental program. It is clear that we have a

¹⁰⁷ COUNCIL ON ENVIRONMENTAL QUALITY, ENVIRONMENTAL QUALITY 348-56 (4th Annual Report 1973).

¹⁰⁸ William Baumol and I are preparing a survey of this evidence to appear as part of our forthcoming book, *Economic Policy for the Quality of Life*.

¹⁰⁹ See B. ACKERMAN, *supra* note 1, at 276-78.

¹¹⁰ *Id.* 282-85.

¹¹¹ See *id.* 209-10.

¹¹² See *id.* 317-30.

great distance yet to travel to our objective of a rational, efficacious policy for the protection of the environment.

What is perhaps most disheartening about this are the recurring lapses in understanding in policy determination in the most critical places. Not long ago, for example, Congress enacted the extensive Federal Water Pollution Control Act Amendments of 1972 with the nonsensical declaration that "it is the national goal that the discharge of pollutants into the navigable waters be eliminated by 1985."¹¹³ Such flights of fancy indicate the pervasive character of certain fundamental misconceptions regarding environmental policy and, in the end, serve to confuse and impede any real progress toward the realization of a reasonable set of environmental objectives. And on the administrative side, we witness such things as the agonizing delays and time extensions to meet emission requirements for new automobiles followed by recent reports of the ineffectiveness of the new emission-control devices. All in all, there is much evidence to support the authors' closing statement:

What is disappointing, even alarming, is the prospect of government, frustrated by the difficulty of structuring a coherent response, embarking on an urgent quest to achieve a poorly defined goal without institutions present to raise the right questions, and without the regulatory tools to achieve objectives either efficiently or fairly. The environmental revolution of the 1970's suggests that we have yet to learn the lessons of the 1960's. After all these lessons have been mastered, however, we shall only have taken the first step toward a system of government that will permit modern men to live in harmony with themselves and nature.¹¹⁴

Yet the limited perspective of the Delaware hides some real progress elsewhere. Regarding air pollution, for example, the last decade has witnessed quite striking reductions in the sulphur and particulate content of the atmosphere over most of our major cities (as well as many cities abroad).¹¹⁵ And new programs, such as Oregon's requiring deposits for beverage containers, are showing encouraging results for the recycling of

¹¹³ 33 U.S.C. § 1251(a)(1) (Supp. III, 1973). See B. ACKERMAN, *supra* note 1, at 319-25.

¹¹⁴ B. ACKERMAN, *supra* note 1, at 330.

¹¹⁵ COUNCIL ON ENVIRONMENTAL QUALITY, *supra* note 107, at 273.

solid wastes.¹¹⁶ In the water resource field itself there is some evidence of reduced waste discharges in response to municipal waste-treatment fees.¹¹⁷ Progress, however, is slow and difficult; it is the important contribution of this book to help us to understand why this is so and to face up to the basic dilemmas and tradeoffs inherent in the quest for environmental quality.

¹¹⁶ D. Waggoner, Oregon's Model Bill, Two Years Later (May 1974).

¹¹⁷ Elliott & Seagraves, *User Charges as a Means for Pollution Control: The Case of Sewer Surcharges*, 3 BELL J. ECON & MGMT. SCI. 346 (1972).